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No.

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IN THE
Supreme Court of the United States

OCTOBER TERM, 1985

WILLIAM FRESCHI, JR., AS TRUSTEE OF
WILLIAM FRESCHI TRUST,
PETITIONER,

v.

GRAND COAL VENTURE, ET AL.
RESPONDENTS.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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Questions Presented for Review

Is it permissible for a court of appeals, in calculating damages under the antifraud provisions of the Securities Exchange Act of 1934, to reduce the damage award to a defrauded plaintiff/investor by an amount equal to the reduction in his tax liability resulting from the write-off of his entire investment in the fraudulent tax shelter?

In light of the publication on July 1, 1985 of this Court's decisions in *Sedima, S.P.R.L. v. Imrex Co.*, 53 U.S.L.W. 5034 (U.S. July 1, 1985) and *American National Bank and Trust Company of Chicago v. Haroco*, 53 U.S.L.W. 5067 (U.S. July 1, 1985), did the court of appeals on July 5, 1985 properly affirm a denial, solely for the failure to allege a "separate racketeering injury," of the Petitioner's motion to amend his complaint to add a count based on a violation of the Racketeer Influenced and Corrupt Organization Act of 1970?

Parties

Petitioner — plaintiff-appellee below — is William Freschi, Jr., as Trustee of William Freschi Trust.

Respondents — defendants-appellants below — are Bandler & Kass, Ground Production Corporation, William J. Werner, Jack Mitnick, Robert Sylvor, H. Jean Baker and William Sherr.

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RESPONDENTS.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Petitioner William Freschi, Jr. (the "Petitioner"), as Trustee of William Freschi Trust (the "Trust"), respectfully petitions this Court, pursuant to 28 U.S.C. § 1254(1) and Rule 19 of the Rules of this Court, for a writ of certiorari to the United States Court of Appeals for the Second Circuit in the case of *Freschi v. Grand Coal Venture, et al.*, 1985 Fed. Sec. L. Rep. (CCH) ¶92,204 (2d Cir. July 5, 1985).

Opinions Below

The opinion of the court of appeals, entered on July 5, 1985, is reported at 1985 Fed. Sec. L. Rep. (CCH) ¶92,204 (2d Cir.

July 5, 1985) and is set forth in Appendix A. The opinion of the district court denying Respondents' motion under Fed. R. Civ. P. 60(b) is reported at 103 F.R.D. 606 and is set forth in Appendix B. The opinion of the district court offering a remittitur which did not recognize the plaintiff's reduction in federal and state income tax liability resulting from a "write-off" of his entire investment in a fraudulent tax shelter in calculating the value of the remittitur and affirming the jury verdict as to the liability of the Respondents is reported at 588 F. Supp. 1257 (S.D.N.Y. 1984) and is set forth in Appendix C. The decision of the district court denying plaintiff's motion to amend his complaint to add a count based on the Racketeer Influenced and Corrupt Organizations Act of 1970 is reported at 583 F. Supp. 780 and is set forth in Appendix D.

Jurisdiction

The judgment of the court of appeals reversing in part the district court was entered on July 5, 1985. This Court has jurisdiction to review the decision of the court of appeals under 28 U.S.C. § 1254(1).

Statutory Provisions

The following statutes are the focus of this petition: section 28(a) of the Securities Exchange Act of 1934, as amended ("1934 Act"), 15 U.S.C. § 78bb(a), which is attached as Appendix E; and sections 1962 and 1964 of the Racketeer Influenced and Corrupt Organizations Act of 1970 ("RICO"), 18 U.S.C. §§ 1961-1968, which are attached as Appendix F.

Statement of the Case

Petitioner is the trustee of a life interest trust funded in 1977 by his father, William Freschi, Sr., from the proceeds of

the sale of the family's business. In an attempt to reduce the income taxes payable as a result of the sale and with an expectation of future income, Petitioner invested in Grand Coal Venture ("Grand Coal"), which Respondents had fraudulently promoted as a coal exploration and production enterprise, as well as an investment which would provide a substantial reduction in federal and state income tax liabilities for the Trust. Petitioner made direct cash investments totalling $266,500 in Grand Coal.

Grand Coal was organized by Respondents Werner, Sylvor and Sherr, partners in the Respondent New York law firm of Bandler & Kass.[1] Respondent H. Jean Baker, a Wyoming resident, was, without benefit of formal education or experience, a self-styled "geologist." His report stating that there was a strong likelihood of large coal deposits on land leased by the venture was included in the Grand Coal offering material. Respondent Jack Mitnick acted as "Venture Administrator" for Grand Coal.

In 1977, a securities salesman knowing of the investment needs of Petitioner suggested an investment in Spruce Productions, Inc. ("Spruce"), a coal lease tax shelter investment vehicle being organized by Werner, Sylvor and Sherr. These lawyers had been representing Joseph Laird while he was under investigation by the Securities and Exchange Commission ("SEC") for marketing fraudulent coal leases. Knowing that the SEC "wanted to put Laird out of business," Werner, Sylvor and Sherr determined to take Laird's place in marketing the leases if Laird was forced to cease operating. These Respondents began doing so, through Spruce, at least as early as December 1, 1977. On December 8, 1977, a temporary restraining order ("TRO") was entered by the United States District Court for the Central District of California

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[1] Sherr has since left the partnership, having been convicted of perjury in an unrelated matter. *United States v. Sherr*, 533 F. Supp. 728 (S.D.N.Y. 1982).

barring Laird and certain other parties, including his attorneys — *inter alia*, the Respondent New York attorneys, from marketing unregistered coal leases to the public. *Securities and Exchange Commission v. Cal-Am Corp.*, No. 77-4586 (C.D. Cal. Dec. 8, 1977). Werner was personally served with a copy of the TRO on December 14, 1977.

At this time, Petitioner had already decided to invest in Spruce. Werner, Sylvor, and Sherr believed that their acceptance of Petitioner's investment in Spruce would violate the TRO. Accordingly, they decided to withdraw Spruce and to replace it with another entity offering substantially the same leases through dummy corporations, thus attempting to evade the prohibitions of the TRO. Werner informed Petitioner, in a December 15, 1977 telephone conversation, that the Spruce offering was being withdrawn, but would be replaced by a very similar offering. The reason given by Werner for the change was that he had just met with United States Internal Revenue Service ("IRS") officials and it had proved necessary to revise the offering to conform with new IRS regulations. No such meeting with IRS officials, in fact, had occurred.

In furtherance of their scheme, Werner, Sylvor, and Sherr formed Ground Production Corporation ("Ground") which procured coal leases from an entity which Laird in turn had formed in a like attempt to circumvent the TRO. Werner, Sylvor, and Sherr then formed Grand Coal, which obtained coal leaseholds from Ground. Finally, to assist them in their scheme, Werner, Sylvor and Sherr hired Baker, a former associate of Laird's. Baker's report, included in the offering materials, stated that there was a strong likelihood that the leased North Dakota lands contained large reserves of sub-bituminous coal. Testimony from a North Dakota State Geologist revealed that sub-bituminous coal is not present anywhere in the State of North Dakota.

In late December, 1977, when Petitioner decided to invest in Grand Coal, he was not informed by the Respondents (nor was he otherwise aware) of the TRO or Laird's troubles with the SEC. As the court of appeals found, Laird's transactions had not "achieved the sort of notoriety which would have put Freschi on notice that he was dealing with swindlers."[2] In late December, 1977, Petitioner's check for $130,000 payable to Bandler & Kass, Special Account, was delivered to Respondents as the first installment of payments to Grand Coal which eventually totalled $266,500.

During 1978, Respondents Mitnick and Werner made false and misleading statements about Grand Coal's operations to assure Petitioner that all was well. Apart from some sham exploration activities, the Respondents made no attempt to mine coal on any of the leases held by the enterprise.

Petitioner's father (the beneficiary and grantor of the Trust) claimed tax deductions for Grand Coal investments of $520,000 in each of 1977 and 1978. These deductions, representing payments on non-recourse notes, were intended to have the effect of reducing his federal tax liability for the two years by $337,033.66 and $322,813.01, respectively. The IRS disallowed all of these deductions because "no coal reserves have ever been produced" and "the chances of actual payment is nil" and assessed a deficiency against Petitioner's father. It also assessed an interest penalty of approximately $264,500. Because the Trust lost its entire cash in-

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[2] The court of appeals included the following footnote (number 13) at the end of its opinion:

> Because the attorney-defendants in this case (Werner, Sylvor, Sherr, and Mitnick) committed actions raising serious questions as to their professional integrity, and because it is not clear from the record exactly what disciplinary action has been taken against them, we instruct the clerk to send copies of this opinion to the appropriate professional conduct review committees.

Appendix A at p. A20.

vestment due to the fraud committed by the Respondents, the IRS eventually allowed a deduction for tax year 1977 for $266,500, representing a write-off of the entire investment. This resulted in an aggregate reduction in federal and state tax liability of $188,682. Petitioner's father's losses due to the investment in the fraud amounted to the total investment of $266,500, plus $659,846.67 in deficiencies assessed by and paid to the IRS for the disallowed deductions, plus $264,500.00 in interest and penalties assessed by and paid to the IRS, all directly resulting from the activities of the Respondents who promoted the fraudulent enterprise.

Procedural History

Prior to trial, the district court dealt with various motions; *inter alia*, Petitioner was denied leave to amend his complaint to add a cause of action under RICO. *Freschi v. Grand Coal Venture*, 583 F. Supp. 780, 787-88 (S.D.N.Y. 1984), Appendix D at pp. A46-49.

Petitioner's suit against Grand Coal and its various principals and agents was tried before a jury in May 1984. The jury returned a special verdict form finding all defendants liable to Petitioner, both directly and as aiders and abettors, for violations of Rule 10b-5; all defendants except Sherr liable to Petitioner for state law fraud; and Bandler & Kass, Werner, Sylvor, and Sherr liable to him for legal malpractice. The jury awarded damages of $440,000.00 on the legal malpractice claim. For the Rule 10b-5 and state fraud violations, the jury awarded combined damages of $926,346.07, "plus all expenses incurred in both this action and actions before the tax courts plus interest due IRS on any deficiencies, including plaintiff's attorneys' fees." The jury further "suggested" that part of the damage award "be held in some type of escrow account" and awarded only if Petitioner, who was

challenging the IRS deficiency assessment, ultimately suffered the full tax losses being assessed.

On a motion by the defendants, the district court rendered judgment *non obstante veredicto* on the legal malpractice count, and, disallowing that part of the award based on increased tax liability, offered Petitioner a remittitur of the remaining damage award from $926,346.07 to $266,500, the amount of his investment, plus pre-judgment interest of $126,681.75. Petitioner accepted the remittitur offer. Respondents filed a timely appeal to the Court of Appeals for the Second Circuit and Petitioner filed a timely cross-appeal.

The court of appeals reversed the finding of liability as to Mitnick on the 10b-5 count, affirmed the other findings of liability, reduced the damages to $77,818 by offsetting the "out-of-pocket" damages of $266,500 by $188,682 in tax liability reductions, and remanded the action for further proceedings. In reducing the damages, the court of appeals relied on its recent decision in *Salcer v. Envicon Equities Corp.*, 744 F.2d 935 (2d Cir. 1984), petition for cert. filed, No. 84-1447 (U.S. March 13, 1985) ("*Salcer*").

The court of appeals also denied Petitioner's request for an instruction to the district court to allow him to proceed, *inter alia*, on the RICO count contained in the motion to amend previously denied by the district court.

Reasons for Granting the Writ

This case squarely presents an issue that has never been decided by this Court: the effect of a reduction in tax liabilities based on a total write-off of an investment on the measure of damages in a suit brought under section 10(b) of the 1934 Act (and rule 10b-5 promulgated by the SEC thereunder). The resolution of this issue is important because the issue may arise in virtually all private actions under federal

securities litigation[3], and it is necessary because the Circuits are divided.[4]

The decision by the court of appeals below is plainly wrong. Unless reversed, the decision, which rewards the Respondents' fraudulent efforts by leaving them with nearly $200,000 of Petitioner's money, will encourage the specific activities which Congress intended the 1934 Act (and the federal securities law generally) to discourage. Neither the language of the 1934 Act nor its legislative history compel, or even support, such a result. Considerations of public policy certainly favor a different rule. Under the Second Circuit's decision, damages resulting from the fraudulent sale of securities are mitigated to the extent there is any reduction in tax liability, and thus the cost of the fraud is borne not only by the defrauded investor but by the federal government as well. The Second Circuit's interpretation of the 1934 Act will encourage securities fraud and, by discouraging private enforcement, will further insulate "swindlers" from any liability for damages resulting from securities fraud.

The court of appeals should have applied the "collateral source" or "tax benefit" rule which traditionally has been applied to the assessment of damages in tort and fraud cases. Under these rules, benefits received by a plaintiff from third parties are not credited against a defendant's liability.

The court of appeals also should have given full retroactive effect to pending cases of this Court's decisions in *Sedima, S.P.R.L. v. Imrex Co.*, 53 U.S.L.W. 5034 (U.S. July 1, 1985) ("*Sedima*"), and *American National Bank and Trust Company of Chicago v. Haroco, Inc.*, 53 U.S.L.W. 5067 (U.S. July 1, 1985) ("*Haroco*"). The Second Circuit's affirmation of the district court's denial of Petitioner's motion to amend to add

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[3] The issue also arises in private suits brought under the Commodity Exchange Act. *See Merrill Lynch, Pierce, Fenner & Smith v. Curran*, 456 U.S. 353 (1982).

[4] See p. 16, *infra*.

a RICO count was based on the Second Circuit's theory that the petitioner needed to show a separate racketeering injury. Since that theory was rejected by this Court four days earlier in *Sedima* and *Haroco*, the Second Circuit erred in not applying those decisions to the district court's ruling on Petitioner's motion to amend.

Argument

A. *The Damage Award*

Based on the principles the Second Circuit had announced in *Salcer*, the court of appeals concluded that the reduction in tax liability of the plaintiff must be deducted from the district court's judgment of $266,500 because the Trust's "actual loss" was only $77,818. The effect of this decision is to reward the purveyors of fraud by leaving with them nearly $200,000 of the Petitioner's funds.

1. *Language of 1934 Act*

To determine whether a reduction in tax liability based on a write-off of an investment in a fraudulent tax shelter must be taken into account in computing damages under the 1934 Act[5] "the starting point," as this Court has emphasized, "is the language [of the statute] itself." *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 197 (1976). Section 28(a) of the 1934 Act provides in relevant part:

> The rights and remedies provided by this chapter shall be in addition to any and all other rights and remedies that may exist at law or in equity; but no person permitted to

[5] Resolution of the tax offset question presented by this case in the context of the 1934 Act would apply as well to the Securities Act of 1933 ("1933 Act"). Although the 1933 Act has no provision comparable to section 28 of the 1934 Act, the courts measure damages under both Acts in similar fashion. See generally, III L. Loss, Securities Regulation 1721 (2d ed. 1961).

> maintain a suit for damages under the provisions of this chapter shall recover, through satisfaction of judgment in one or more actions, a total amount in excess of his actual damages on account of the act complained of. . . .

15 U.S.C. §78bb(a), Appendix E at p. A51.

The conclusion reached by the Second Circuit, however, follows from a misperception of what the 1934 Act intended by the phrase "actual damages." The structure and legislative history of section 28(a) suggest that the limitation of damages to "actual damages on account of the act complained of" is to prevent duplicative recovery by a plaintiff asserting claims in different forums, and to exclude speculative damages from any recovery.

The first sentence of section 28(a) provides that the rights and remedies provided by the 1934 Act are "in addition to any and all other rights and remedies that may exist at law or in equity." The purposes of this sentence is to make clear that federal remedies do not pre-empt remedies that may exist under state laws. The phrase "actual damages," which immediately follows in section 28(a), is thus designed to prevent a plaintiff from recovering more than once for the same violation or cause of action. *E.g., Osofsky v. Zipf,* 645 F.2d 107, 111 (2d Cir. 1981).

Indeed, in *Osofsky v. Zipf,* the Second Circuit traced the phrase "actual damages" as used in the 1934 Act to earlier enacted patent statutes:

> Although the term 'actual damages' is not defined in the statute itself, it had an accepted meaning when the Securities Exchange Act was enacted in 1934. As used in the patent statutes, for example, the term had been construed as requiring damages to be 'given as a compensation, recompense or satisfaction to the plaintiff for an injury actually received.' *Birdsall v. Coolidge,* 93 U.S. 64, 64, 23 L.Ed. 802 (1876).

Id. at 111.

Further, under federal copyright and trademark statutes where the term "actual damages" has been analyzed, this Court consistently has denied any reduction in "actual damages" arising from either income taxes paid by an infringer or income taxes payable by the owner of the right. *See Sheldon v. Metro-Goldwyn Pictures Corp.*, 309 U.S. 390 (1940), affirming 106 F.2d 45 (2d Cir. 1939), and *Larson Co. v. Wrigley Co.*, 277 U.S. 97 (1929). The language of the 1934 Act is not even susceptible of the reading of section 12(2) of the 1933 Act which the Eighth Circuit applied in *Austin v. Loftsgaarde*, Fed. Sec. L. Rep. (CCH) ¶92,214 (8th Cir. July 16, 1985), where reduction in tax liability was equated with "income received" on an investment.[6]

Thus, the decision of the Second Circuit cannot be said to be compelled or supported by the express language of the 1934 Act.

2. *Intention of 1934 Act*

Under circumstances where the language of the statute may be vague, this Court has relied on "practical factors" and "considerations of policy" to interpret the intent of Congress. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 749 (1975). One of the purposes of the 1934 Act is to promote confidence in the domestic capital markets by discouraging fraud. Thus all practical and policy considerations favor excluding any reduction in tax liability — particularly those unrelated to any return from the investment — in the calculations of damages to defrauded investors. Indeed, the rule applied by the Second Circuit in the case below runs counter to the policy considerations previously enunciated by that court

[6] In cases under section 12(2) of the 1933 Act, where damages equal consideration paid for the investment less "income received," the offset is not reduced to give effect to the taxes paid by the investor on the "income received." There is no "after-tax" application in the damage calculation.

in a prior securities fraud decision in which the court applied a liberal damages rule. *Chasins v. Smith, Barney & Co.*, 438 F.2d 1167, 1173 (2d Cir. 1970). The rule, at least as applied in this case, is an incentive to commit fraud in the sale of securities. Certainly, a more effective deterrent to such activity would be to assess against the Respondents an amount equal to the out-of-pocket damages of Petitioner together with consequential damages, such as tax deficiencies, and interest and penalty payments.

3. *General Implication for the Federal Securities Laws*

The court of appeals' holding runs contrary to the policy underpinnings of the federal securities laws.

First, in most securities fraud cases, the application of the holding will reduce a defendant's damages. In instances where the investment is induced and promoted by tax laws designed to further socially desirable goals — here, coal exploration — the court of appeals' holding may eliminate damages altogether. Both the tax policy of encouraging certain types of investments and the overall policy of promoting confidence in the domestic capital markets by discouraging securities fraud are undermined when those who are found by a jury to have committed fraud escape with a windfall. The legislative history of the 1934 Act, cited with approval by this Court for other purposes, indicates a directly opposite result:

> '[I]f an investor has suffered loss by reason of illicit practices, it is equitable that he should be allowed to recover damages from the guilty party.' . . .

Ernst & Ernst v. Hochfelder, supra, 425 U.S. at 205, *citing* S. Rep. No. 792, 73d Cong., 2d Sess. 12-13 (1934).

Second, the rule adopted by the Second Circuit will cause serious adjudicatory problems. If the reduction in tax liability is a factor in the award of damages, the courts will be required to undertake complicated computations of expected

tax rates and benefits. An example of the complex computations may be seen in the second section of the opinion of the Eighth Circuit in *Austin v. Loftsgaarden, supra,* ¶92,214 at p. 91, 594 where the court "doubled the damages" to give effect to an assumed 50% federal income tax on the cash damages awarded to the defrauded investors. Such calculations necessarily are based on the extrapolation and application of assumed tax rates which lead to speculatory damages. This will lead to even greater confusion than now exists.

Lastly, the effect of the decision below will be to reduce government revenues and to bring the government into the fraudulent transaction to assist those committing the fraud. By crediting to the Respondents the reduction in tax liability of the Petitioner conferred by the government, the court of appeals' decision effectively brings about a transfer of funds from the government to the Respondents. The Ninth Circuit refers to this situation as the "government [becoming] the banker for fraudulent tax shelter activity." *Burgess v. Premier Corp.,* 727 F.2d 826, 838 (9th Cir. 1984). *See also Western Federal Corp. v. Davis,* 553 F. Supp. 818, 821 (D. Ariz. 1982), aff'd sub nom, *Western Federal Corp. v. Erickson,* 739 F.2d 1439 (9th Cir. 1984).

In general, this Court has viewed the federal securities laws as remedial in nature and in this context consistently has construed them liberally and flexibly to protect investors and the integrity of the capital markets. *See Herman & MacLean v. Huddleston,* 459 U.S. 375, 386 (1983), where section 11 of the 1933 Act and section 10(b) of the 1934 Act were cumulatively construed to further the "broad remedial purposes" of the securities laws. As this Court stated:

> we have repeatedly recognized that securities laws combating fraud should be construed 'not technically and restrictively but flexibly to effectuate [their] remedial

> purposes.' *SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 195 (1963).

Id. at 386-387.

It is difficult to understand how the Second Circuit's decision can be viewed as other than inflexible, restrictive and contrary to the stated policy. It serves only to reward fraud and undermine private enforcement of the securities laws.

The Second Circuit relied heavily on its recent decision in *Salcer, supra.* While the Petitioner believes that the decision in *Salcer* likewise is wrong for these reasons of policy, the facts in this case are very different than the facts in that case. In *Salcer,* the enterprise organized to take advantage of the favorable tax policies was bona fide and the tax deductions taken were based on actual operations of the enterprise. In the instant case, the Respondents did not conduct sufficient operations for the IRS to allow any of the promised deductions to Petitioner, and the actual reduction in tax liability resulted from the loss of the investment. Furthermore, these deductions resulted from Petitioner's actions, not those of the Respondents.

4. *Failure to Apply Collateral Source or Tax Benefit Rules*

The issue presented in this case in the context of the federal securities laws commonly arises in other types of cases: whether insurance benefits or other payments received by a plaintiff should reduce an award of damages. Through invocation of the "collateral source rule," courts have adopted a rule contrary to the rule chosen by the court of appeals in this case. E.g., *Russo v. Matson Navigation Co.*, 486 F.2d 1018, 1020 (9th Cir. 1973) and *Hall v. Chicago & North Western Ry.*, 5 Ill. 2d 135, 151, 125 N.E.2d 77, 86 (1955).

As set forth in the Restatement (Second) of Torts §920A(2):

> Payments made to or benefits conferred on the injured party from other sources are not credited against the

> tortfeasor's liability, although they cover all or a part of the harm for which the tortfeasor is liable.

The commentary states that a "benefit that is directed to the injured party should not be shifted so as to become a windfall for the tortfeasor . . . . If the benefit was a gift to the plaintiff from a third party or established for him by law, he should not be deprived of the advantage that it confers." Restatement (Second) of Torts § 920A Comment b. The reduction in tax liability of the Petitioner should be treated as a benefit subject to the collateral source rule as both received from a third party and established by law. The policies that support the exclusion of collateral sources in the tort area apply *a fortiori* when the tort involves, as in this case, intentional fraud.

The court of appeals also should have applied the "tax benefit" rule. Underlying the court of appeals decision is the unexamined hypothesis that the reduction in tax liability of Petitioner is attributable to the Respondents. Petitioner's reduction in tax liability arose only from the complete loss and subsequent write-off of the entire investment, not by any valid business deductions generated by the operation of the fraudulent activity. Thus, Petitioner's benefit is not related in any way to any act of the Respondents, unless the truly anomolous proposition is advanced that Respondents conferred a benefit upon the Petitioner by defrauding him!

In an analogous situation, where a defendant was found to have violated the antitrust laws in leasing while refusing to sell shoe machinery, this Court held that the damage award was not to be reduced by the additional taxes that the plaintiff would have paid if it had purchased, rather than rented, the machinery. *Hanover Shoe, Inc. v. United Shoe Machinery Corp.*, 392 U.S. 481, 503 (1968). Similar treatment has been accorded by this Court in copyright and trademark cases. *See Sheldon v. Metro-Goldwyn Pictures, supra* (copyright), and *Larson Co. v. Wrigley Co., supra* (trademark).

5. *Split in Circuits*

The importance of resolving the issue presented — because it arises in virtually every private securities fraud case — is clear. In addition, however, the Circuits are at odds on the question. The Ninth Circuit has adopted the rule that damages should not be reduced by the tax benefits received by a plaintiff.[7] *Burgess v. Premier Corp., supra; Western Federal Corp. v. Erickson, supra.* Joining the Second Circuit, in adopting the contrary position, are the Fifth[8] and the Eighth Circuits. *Dupuy v. Dupuy,* 551 F.2d 1005, 1025 (5th Cir. 1977); and *Austin v. Loftsgaarden, supra.* This Court should resolve the conflict and review the decision below.

B. *The RICO Claim*

To decide whether to review Petitioner's request to be allowed to proceed against the Respondents on a RICO count on remand, the Court need look no further than to its recent decisions in *Sedima* and *Haroco* which were decided only four days before the decision was entered in the instant case.

The district court in this action, following the then existing rule of the Second Circuit relating to RICO claims, denied Petitioner's motion to amend the complaint in this action to include a RICO count, reasoning solely that the amendment, if allowed, would be subject to a successful motion to dismiss under Fed. R. Civ. P. 12(b)(6). *Freschi v. Grand Coal Venture,* 583 F. Supp. 780, 788 (S.D.N.Y. 1984), Appendix D, at p. A49. The district court found that a plaintiff seeking to state a civil claim for damages under RICO must allege adequately that (i) the defendant has violated the substantive

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[7] A district court in the Seventh Circuit has held likewise. *Spatz v. Borenstein,* 513 F. Supp. 571, 586 (N.D. Ill. 1981).

[8] See district court's interpretation of Fifth Circuit's position in *Bridgen v. Scott,* 456 F. Supp. 1048, 1061-62 (S.D. Tex. 1978).

RICO statute, § 1962, and (ii) the plaintiff was injured in his business or property "by reason of a violation of §1962."

In referring to the facts of the instant case — *i.e.*, dissemination of false information by the Respondents by mail and wire, and circulation by the Respondents of offering materials containing false information as establishing a "pattern of racketeering activity" — the district court concluded that Petitioner had adequately alleged the necessary predicate acts. Similarly, the district court, in noting the association of the Respondents for the purposes of defrauding Petitioner and other investors and the organization of the various business entities through which the fraud was perpetrated, found that Petitioner adequately alleged an "enterprise" under § 1961(4). However, based on the since rejected restriction placed on civil RICO claims by the Second Circuit, the district court went on to state that the proposed amended complaint failed to allege an injury "by reason of" a § 1962 violation. The district court also stated that in the instant case, "Freschi has alleged no facts to support injury 'by reason of' other than resulting from the alleged predicate acts themselves. For this reason, the RICO cause of action fails to state a claim, and the motion to amend is therefore denied." 583 F. Supp. at 788, Appendix D at p. A49. The district court made no findings which support the denial of the motion to amend on any other basis.

The Second Circuit, in the decision below, cited to the repeated use of the telephone and the mails by the Respondents in affirming the judgments of liability under 10b-5 and state law fraud; however, it followed the district court's lead by not allowing Petitioner to proceed on a RICO claim on remand. This decision apparently was based on the now rejected restriction the district court cited.

The court of appeals may not have had the benefit of the options in *Sedima* and *Haroco* prior to affirming the denial of

Freschi's request for authority to proceed on the RICO count on remand.

In the *Sedima* opinion, this Court rejected the Second Circuit's rule based on the "by reason of" language. In that opinion, this Court stated:

> If the defendant engages in a pattern of racketeering activity in a manner forbidden by these provisions, and the racketeering activities injure the plaintiff in his business or property, the plaintiff has a claim under §1964(c). There is no room in the statutory language for an additional amorphous 'racketeering injury' requirement.

53 U.S.L.W. at 5038.

Additionally, the Court stated:

> Where the plaintiff alleges each element of the violation, the compensable injury necessarily is the harm caused by predicate acts sufficiently related to constitute a pattern, for the essence of the violation is the commission of those acts in connection with the conduct of an enterprise. Those acts are, when committed in the circumstances delineated in §1962(c), 'an activity which RICO was designed to deter.' Any recoverable damages occurring by reason of a violation of §1962(c) will flow from the commission of the predicate acts.

Id. at 5039.

More pointedly, this Court in *Haroco* stated:

> To the extent petitioners' argument is a variation on the racketeering injury concept at issue in *Sedima, S.P.R.L. v. Imrex Co.*, ante, p. _____, it is inconsistent with that decision. The submission that the injury must flow not from the predicate acts themselves but from the fact that they were performed as part of the conduct of an enterprise suffers from the same defects as the amorphous and unfounded restrictions on the RICO private action we rejected in that case.

53 U.S.L.W. at 5068.

The allegations contained in Petitioner's proposed amended complaint bring the complaint within the plain meaning of RICO as enunciated in *Sedima* and *Haroco*.

This Court should review the decision below to ensure that the Second Circuit opinion is reversed, in part, to conform it with this Court's rulings in *Sedima* and *Haroco*.

Conclusion

For the reasons stated, this Court should grant the writ of certiorari to the United States Court of Appeals for the Second Circuit on both issues.

Respectfully submitted,

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September 5, 1985

United States Court of Appeals for the Second Circuit

Nos. 487, 509, 611 — August Term, 1984

(Argued: January 9, 1985 Decided: July 5, 1985)

Docket Nos. 84-7726, 84-7740, 84-7764

WILLIAM FRESCHI, JR.,
AS TRUSTEE OF WILLIAM FRESCHI TRUST,
Plaintiff-Appellee,
Cross-Appellant,

v.

GRAND COAL VENTURE, BANDLER & KASS, GROUND PRODUCTION CORPORATION, WILLIAM J. WERNER, JACK MITNICK, ROBERT SYLVOR, WILLIAM C. SHERR, MINERAL RESOURCES DEVELOPMENT, INC. AND H. JEAN BAKER,
Defendants,

GRAND COAL VENTURE, BANDLER & KASS, GROUND PRODUCTION CORPORATION, WILLIAM J. WERNER, JACK MITNICK, ROBERT SYVLOR, H. JEAN BAKER AND WILLIAM SHERR,
Defendants-Appellants,
Cross-Appellees.

Before:

MANSFIELD, NEWMAN, AND PECK, Circuit Judges.*

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* Of the Sixth Circuit Court of Appeals, sitting by designation.

Appeal from a judgment of the District Court for the Southern District of New York (Robert W. Sweet, Judge) holding defendants Ground Production Corporation, Bandler & Kass, Werner, Mitnick, Sylvor, Sherr and Baker liable for Rule 10b-5 violations, and defendants Ground Production Corporation, Bandler & Kass, Werner, Mitnick, Sylvor, and Baker liable for fraud, and awarding $266,500 in damages, plus pre-judgment interest.

Finding of liability as to Mitnick on 10b-5 count reversed; other findings of liability affirmed; damages reduced to $77,818; remanded for further proceedings.

Neil Schwarzfeld, New York, N.Y. (Alan C. Fried, Schwarzfeld, Ganfer, Shore & Rosenblum, New York, N.Y. on the brief), for defendants-appellants, cross-appellees.

Robert C. Gerrard, Boston, Mass. (Edward N. Perry, Bowker, Elmes, Perkins, Mecsas & Gerrard, Boston, Mass. on the brief), for plaintiff-appellee, cross-appellant.

JOHN W. PECK, *Circuit Judge:*

This is a securities fraud case. Following a jury trial, defendants Ground Production Corporation, Bandler & Kass, William J. Werner, Robert Sylvor, William C. Sherr, H. Jean Baker, and Jack Mitnick, appellants herein,[1] were found liable for violation of Securities and Exchange Commission Rule 10b-5, and all defendants except Sherr were found liable for common law fraud as well. They were ordered to pay plaintiff-appellee William Freschi, Jr., trustee of the William Freschi trust, $266,500 in damages, plus $126,681.75 in pre-judgment interest. *Freschi v. Grand Coal Venture,* 588 F.

[1] The briefs list Grand Coal Venture as a defendant-appellant. Grand Coal Venture, an unincorporated entity, was named as a defendant; there was, however, no finding of liability against it, and it is therefore not a party to the appeal.

Supp. 1257 (S.D. N.Y. 1984). Defendants have appealed, and Freschi has cross-appealed. We affirm the trial court's judgment of liability as to all defendants except Mitnick; the judgment against him is reversed as to Rule 10b-5 but affirmed as to fraud. We also partially reverse the award of damages on the basis of our decision in *William Z. Salcer, Panfeld, Edelman v. Envicon Equities Corp.*, 744 F.2d 935 (2d Cir. 1984), which had not yet been decided when judgment was entered by the district court.

I.

A.

The events leading to this trial began in the summer of 1977, when William Freschi, Sr., the father of plaintiff-appellant, decided to seek a tax shelter for $2,700,000 he had realized from the sale of his interest in a business. Accordingly, he established a trust with his son, William Freschi, Jr. ("Freschi"), as trustee. Freschi decided to invest the trust corpus, which consisted principally of the funds realized from the sale of the business, in operations paying a moderate to high rate of return while offering substantial tax benefits.

A securities salesman suggested that Freschi invest in Spruce Productions, Inc., a venture being organized by appellants Werner, Sylvor, and Sherr. Werner, Sylvor, and Sherr were partners in a law firm, Bandler & Kass, which represented an entrepreneur, Joseph Laird, who was under investigation by the Securities and Exchange Commission ("SEC") for marketing of fraudulent coal leases. Knowing that the SEC "wanted to put Laird out of business," the three partners decided to take Laird's place in marketing the leases if Laird were forced to cease marketing them. The partners began doing so, through an entity called Spruce Productions, Inc., at least as early as December 1, 1977. The Spruce Productions prospectus contained an express warran-

ty that, if the leased property did not contain recoverable coal reserves, the sponsors of the offering would provide substitute property that did contain such reserves. In the prospectus, the sponsors also promised to buy at least 25% of the coal mined at a profit to the investor and to provide free legal representation to investors in the event that IRS disallowed projected tax deductions. On December 8, 1977, with the mutual consent of the SEC, Laird, and other parties not involved in this suit, the United States District Court for the Central District of California issued a temporary restraining order. The order barred Laird and certain other parties, including his attorneys, from marketing unregistered coal leases to the public. *Securities and Exchange Commission v. Cal-Am Corp.*, No. 77-4586 (C.D. Cal. Dec. 8, 1977) (T.R.O.) Werner was personally served with a copy of the order on December 14, 1977.

At this time, Freschi had already decided to invest in Spruce Productions.[2] Werner, Sylvor, and Sherr were aware of the difficulty in accepting his investment without violating the T.R.O., but wished to find a way around the problem. As a result, they decided to scrap Spruce Productions and to replace it with another entity offering substantially the same leases through dummy corporations, thus avoiding the T.R.O.'s bar on sales to the public. Werner thus informed Freschi, in a December 15, 1977 telephone conversation, that the Spruce Productions offering was being withdrawn, but would be replaced by a very similar offering. The reason for the change, Werner told Freschi, was that he had just met

[2] Freschi wrote a check for $130,000 made out to "Bandler & Kass, Special Account" on December 12, 1977. With it he enclosed a handwritten signed note to "Mr. Werner," stating that the check was "to sub lease [sic] coal land and to obtain an advance royalty payment writeoff [sic]." Freschi held the check, however, until December 19; at this time he mailed it to an agent in New York, who tendered the check to Bandler & Kass under circumstances detailed below.

with IRS officials and it had proved necessary to revise the offering to conform with new IRS regulations. No such meeting with IRS officials, in fact, had occurred.

Werner, Sylvor, and Sherr then formed a company known as Ground Production Corporation. Ground Production procured Laird's coal leases from a new company called Tristar Coal Corporation, which we conclude Laird had formed in an attempt to circumvent the T.R.O. Werner, Sylvor, and Sherr also formed an unincorporated organization known as Grand Coal Venture, which in turn obtained coal leaseholds from Ground Production. To assist them in their work, Werner, Sylvor and Sherr hired H. Jean Baker, a self-styled "geologist" without formal training in geology. Baker, a former associate of Laird's, signed a report stating that there was a strong likelihood that the leased lands contained large coal reserves.

Freschi, relying on the previous assurances that the Grand Coal Venture offering was essentially the same as the earlier Spruce Productions offering, took steps to invest in Grand Coal Venture. At this point, no one had told Freschi of Laird's difficulties with the SEC or of the temporary restraining order; Freschi's assumption was that Werner had truthfully told him the deal was being restructured due to tax problems. Freschi took independent action to verify the soundness of the projected investment. He consulted an accountant, had the trust's attorney call Werner to discuss the deal and its tax consequences, and retained an agent to verify that Bandler & Kass was a reputable law firm. This agent was satisfied by his investigation, and acting on behalf of Freschi, tendered a check for $130,000 of the trust's funds to Bandler & Kass as the first installment of payments to Grand Coal Venture which eventually were to total $266,500. This first payment was made on December 21, 1977; the documents evidencing the trust's investment were dated December 29, 1977.

Freschi did not receive Grand Coal Venture's offering memorandum until March 31, 1978. This memorandum revealed that, in spite of Werner's earlier assurances about the similarity between the Grand Coal Venture offering and the Spruce Productions one, there were some rather significant differences. Most significantly, the Grand Coal Venture offering lacked the assurances the earlier offering had contained about the profitability of the venture, and indeed contained specific caveats as to the riskiness of the investment. The memorandum, which was a long and complex document (totalling 167 pages), also contained what appeared to be substantial similarities to the Spruce Productions offering: it dealt with coal leases in the same general region, it contained figures at the outset purporting to set forth the "total minimum" return on the investment, and, most importantly, to Freschi, it offered the same tax advantages as had the original offering. The memorandum also incorporated Baker's optimistic "geologist's report."

Upon receiving the memorandum, Freschi began a further investigation designed to insure that his investment was a viable one. His investigation included consultations with his accountant, his attorney, Sherr, a coal mining executive, an attorney specializing in coal leases, and a geologist, who accompanied Freschi to a meeting with Baker. The investigation took place over a period of three months and involved trips from Freschi's home in San Francisco to New York and Denver as well as communications by telephone and mail. Nothing in this rather thorough investigation suggested to Freschi that he was the victim of fraud.

In August, 1978, Jack Mitnick, who acted as "Venture Administrator" for Grand Coal Venture, sent investors a letter, drafted by Sylvor, stating that the leased land did not contain commercially recoverable quantities of coal. The letter further stated, however, that Grand Coal Venture's sublease from Ground Production contained an express warranty that

Ground Production would, under such circumstances, give Grand Coal Venture replacement leases containing commercially recoverable coal reserves — a statement which was not true. "Accordingly," the letter continued, "demand has been made of Ground that it immediately furnish you with suitable subleases . . . containing economically recoverable coal reserves . . ." Ground Production actually did give Grand Coal Venture a replacement lease, similarly worthless, in December 1978. Mitnick and Werner continued to assure Freschi that all was well at regular intervals through December 1980. The trust, however, never received any profits on its investment. Finally, Freschi, his patience exhausted, filed the instant suit on July 13, 1981, in the United States District Court for the Southern District of New York.

B.

Freschi was, as we have noted, interested in Grand Coal Venture largely as a tax shelter. At the time of his investment, the tax laws offered large deductions for coal mining investments, as part of a national policy of developing American energy self-sufficiency.

Because Freschi's father was the sole beneficiary of the trust, the trust was not a separate taxpaying entity; all taxes on trust income were assessed directly against the senior Freschi, but paid from the trust corpus. Freschi's father claimed tax deductions for Grand Coal Venture of $520,000 in both 1977 and 1978. These deductions reduced his tax bill for the two years by $337,033.66 and $322,813.01, respectively. IRS ultimately disallowed these deductions and assessed a deficiency against the senior Freschi. It also assessed an interest penalty of approximately $264,500. IRS eventually allowed the senior Freschi, however, to claim a deduction for 1977 for his $266,500 lost investment. This deduction resulted in total federal and state tax savings for the elder

Freschi of $188,682. Thus Freschi's actual out-of-pocket loss on his investment was $77,818; because of the failure of his tax shelter he was required to pay IRS $659,846.67 on account of the disallowed deductions, plus the $264,500 interest penalty.

C.

Freschi's suit against Grand Coal Venture and its various principals and agents was tried before a jury in May 1984.[3] The jury returned a special verdict form finding all defendants liable to Freschi, both directly and as aiders and abettors, for violations of Rule 10b-5; all defendants except Sherr liable to Freschi for state law fraud; and Bandler & Kass, Werner, Sylvor, and Sherr liable to him for legal malpractice. The jury awarded damages of $440,000 on the legal malpractice claim. For the Rule 10b-5 and state fraud violations, the jury awarded combined damages of $926,346.07, "plus all expenses incurred in both this action and actions before the tax courts plus interest due IRS on any deficiencies, including plaintiff's attorneys' fees." The jury further "suggested" that part of the damage award "be held in some type of escrow account" and awarded only if Freschi, who was challenging the IRS deficiency assessment, ultimately suffered the full tax losses he claimed. On a motion by the defendants, the trial judge rendered judgment non obstante veredicto on the legal malpractice count, and, disallowing that part of the award based on increased tax liability, offered Freschi remittitur of the remaining damage award

[3] Prior to trial, the court dealt with various motions; *inter alia*, the court denied Freschi leave to amend his complaint to add a cause of action under the Organized Crime Control Act of 1970 ("RICO"), Pub L. 91-457, 84 Stat. 941, 18 U.S.C. § 1961 *et seq.* *Freschi v. Grand Coal Venture*, 583 F. Supp. 780, 787-88 (S.D.N.Y. 1984). At the close of the evidence and before submission of the case to the jury, the court directed a verdict for defendants on a breach of contract cause of action.

from $926,346.07 to $266,500, the amount of his investment, plus pre-judgment interest of $126,681.75. Freschi accepted the remittitur offer. Defendants filed a timely appeal to this court, and Freschi filed a timely cross-appeal.[4]

II.

A.

The first issue we must address is whether the findings of liability against all appellants on the 10b-5 count, and against all appellants except Sherr on the state law fraud count, can stand. Appellants argue that Freschi's claim against them on these counts was barred by California's three-year statute of limitations for fraud when Freschi filed the action in July 1981.

Freschi and the appellants agree that the three-year California statute of limitations for fraud governs both the fraud and the Rule 10b-5 causes of action.[5] They also agree that the causes of action accrued when Freschi discovered the alleged violations or should, upon reasonable inquiry, have discovered them.[6] *Arneil v. Ramsey*, 550 F.2d 774, 780 (2d Cir. 1977); *Korn v. Merrill*, 403 F. Supp. 377, 387

[4] Because Freschi accepted the trial court's offer of remittitur, he conditioned his cross-appeal on this court's altering the remittitur offer.

[5] Rule 10b-5, like many federal causes of action, has no express statute of limitations. Accordingly, the federal courts adopt the most analogous state statute of limitations. Both parties agreed that the statute of limitations for fraud was the most analogous limitations statute, and further agreed that the law of the forum state, New York, would apply the limitations statute of California, the state of plaintiff Freschi's residence.

[6] While the federal courts adopt the analogous state statute of limitations in 10b-5 actions, the time at which the plaintiff's cause of action accrues is a question of federal law. *See, e.g., Phillips v. Levie*, 593 F.2d 459, 462 (2d Cir. 1979); *Arneil v. Ramsey*, 550 F.2d 774, 780 (2d Cir. 1977).

(S.D.N.Y. 1975), *aff'd*, 538 F.2d 310 (2d Cir. 1976).[7] They disagree, however, on the crucial issue of when Freschi should have discovered, upon reasonable inquiry, that he was the victim of a fraud. Appellants assert that he should have become aware of this fact on March 31, 1978, when he received the Grand Coal Venture offering memorandum which, they allege, stated terms materially different from those which he had thought governed his investment. If this claim is accepted, the finding of liability must be reversed, as Freschi's time for bringing suit would have expired over three months before he filed suit in July 1981.

The question was submitted by the trial court as a question of fact to the jury, which returned a finding that the three-year statute of limitations did not bar the suit. Appellants do not contend that the trial court erred by submitting the question to the jury as one of fact; we must review this question as one of fact, and can reverse only if we conclude that the jury's finding was not supported by any substantial evidence.

We conclude that there was substantial evidence to support this jury finding, and therefore we affirm it. We have already detailed the rather painstaking investigation Freschi undertook on receiving the offering memorandum. While it is possible that some investors might have undertaken an even more thorough investigation, there was substantial evidence for the jury to find that this investigation satisfied the requirement of due diligence, and therefore to find that the statute of limitations did not bar the claim.

We note that the trial court's charge to the jury with regard to the statute of limitations, while correct in most particulars, placed the burden of proving that Freschi failed to

[7] A long series of cases establishes the need for due diligence on the part of a plaintiff in order to toll a statute of limitations for fraud. *See, e.g., Bailey v. Glover*, 88 U.S. (21 Wall.) 342, 348-49 (1874); *Robertson v. Seidman & Seidman*, 609 F.2d 583, 585 (2d Cir. 1979); *Phillips v. Levie*, 593 F.2d 459, 462 (2d Cir. 1979); *Berry Petroleum Co. v. Adams & Peck*, 518 F.2d 402, 410 (2d Cir. 1975).

exercise diligence on the defendants. The burden ought to have been on Freschi as plaintiff to prove his diligence as the prerequisite to allowing equitable tolling of the limitations statute. *See, e.g., City of Detroit v. Grinnell Corp.*, 495 F.2d 448, 461 (2d Cir. 1974); *Long* v. *Abbott Mortgage Corp.*, 459 F. Supp. 108, 116 (D. Conn. 1978). Defendants, however, did not object to this aspect of the instructions at trial, and have not, in fact, raised it as an issue on appeal. We are not convinced that the trial judge's instruction in this regard was such plain error as to warrant reversal in the absence of an objection, timely or otherwise, by the parties arguably harmed[8] by the instruction. *See* Fed. R. Civ. P. 51.

B.

Having concluded that Freschi's suit was not barred by the applicable statute of limitations, we now proceed to consider whether defendants' conduct contained the elements of common law fraud and of Rule 10b-5 violations. In doing so, we first consider the elements of each cause of action, and then consider separately whether each party was properly found liable.

SEC Rule 10b-5, 17 C.F.R. § 240.10b-5, states:

> § 240.10b-5 Employment of manipulative and deceptive devices.
>
> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

[8] We say "arguably harmed" because we are not persuaded that the instruction constituted anything more than harmless error, given the evidence for the exercise of due diligence on Freschi's part. Because we base our decision on this point on the lack of an objection, it is unnecessary, however, for us to decide whether the instruction did constitute harmless error, and we refrain from doing so.

> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Thus a 10b-5 violation has two essential elements, the use of the mail, an instrumentality of interstate commerce, or a securities exchange facility, and a fraudulent scheme or untrue or misleading statement. Case law has further clarified the prerequisites for a 10b-5 action by a private party, and has established that the plaintiff must have been the purchaser or seller of a security, that the deceptive conduct must have occurred in connection with the purchase or sale of the security, and that the defendant or defendants must have acted with scienter. *See generally* T. Hazen, The Law of Securities Regulations § 13.2 (1985).

With respect to appellant Werner, the evidence of a 10b-5 violation is overwhelming. Werner repeatedly used the telephone, an instrumentality of interstate commerce, to induce Freschi to invest in Grand Coal Venture. In so doing, he misrepresented to Freschi that the prior Spruce Productions offering was withdrawn because of tax problems. This was a lie, and Werner knew it. The evidence establishes that Werner withdrew the Spruce Productions offering because he was under a court order not to market it. It further establishes that the court order stemmed from activities by a client of Werner's in marketing a similar offering which had aroused the suspicion of the SEC.[9] Werner asserts the misin-

[9] In *SEC v. American Bd. of Trade, Inc.*, 751 F.2d 529, 540-41 (2d Cir. 1984), we held that it was not improper for the defendant in that action to fail to disclose the existence of a preliminary injunc-

formation he gave Freschi and the information he failed to give Freschi were not material. This contention is frivolous. Any reasonable investor would be interested in knowing that the SEC was concerned about possible fraud in connection with a securities offering which the offeror himself described as "basically similar" to the one under consideration for investment. Indeed, if Werner did not consider the fact important, it is difficult to understand why he found it necessary to lie to Freschi about it. Werner not only gave Freschi a false reason for the change in the leases being offered, but failed to tell Freschi that the source of the new leases was an individual the SEC suspected of fraud. We cannot find that it was unreasonable for the jury to consider these misstatements and omissions material; in fact, we are inclined to think that it would have been unreasonable for the jury to have done otherwise.

Werner's argument that he acted without scienter is just as frivolous. Werner knew that the reasons he gave for the change in the offering were not true, and he knew about the court order which was the real reason for the change; indeed, he had been personally served with a copy of it when he made the false and misleading statements to Freschi.

The only remaining issue with respect to Werner's 10b-5 liability, then, is whether Freschi relied on his statements and whether such reliance was reasonable. Freschi testified that he relied on Werner's statements in making the investment decisions on behalf of the trust, and the circumstances support his testimony. At the time of Freschi's December 15 conversation with Werner, he had decided to invest the trust's funds in Spruce Productions; the offering, however, had been

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tion against it to potential investors. The circumstances of that case were very different, however; as we specifically noted, the preliminary injunction in that case was prompted, not by intentional misconduct, but by a bona fide disagreement between defendant and the SEC as to the interpretation of very technical regulations.

withdrawn. Four days after the conversation, Freschi authorized his agent to investigate Bandler & Kass and, if satisfied, invest the trust's funds in the replacement offering, Grand Coal Venture. Even without Freschi's testimony, the conclusion that he relied on Werner's assurances in deciding to invest in Grand Coal Venture would be compelling.[10]

The jury was justified in concluding that Freschi's reliance on Werner's statements was reasonable. There was no particular reason for Freschi to suspect that the undertaking was a fraudulent one. No evidence has been presented indicating that Laird's transactions had achieved the sort of notoriety which would have put Freschi on notice that he was dealing with swindlers. Appellants suggest that Freschi ought to have made an independent investigation into whether the leased property actually contained coal reserves. There is respected authority suggesting that such investigation by an investor in mining operations is not necessary. *See Securities & Exchange Comm'n v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 862-63 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969) (considering the existence of a private cause of action for investors misled by company misrepresentations as to the presence of mineral reserves without any suggestion that investors should have made their own geological investigations).

Freschi, moreover, did undertake some independent effort to verify the soundness of the offering, as noted above: he obtained legal and accounting advice and sent an agent to in-

[10] Appellants contend that the potential profitability of the venture was irrelevant to Freschi's investment decision, as the trust's only interest, they allege, was in finding a tax shelter. Apart from the fact that the only bona fide investments are eligible for tax preferences, this argument is rebutted by Freschi's testimony that he was interested in finding an investment offering both tax advantages *and* a reasonable return. The fact that Freschi took steps, after receiving the offering memorandum, to verify that the leased lands did contain coal supports his assertion that he was concerned with the venture's potential for profit.

spect the offices of Bandler & Kass to determine that it was a legitimate law firm. To assert that Freschi's efforts to verify the information he received were insufficient to make his reliance reasonable is tantamount to asserting that he should have suspected fraud from the start. As we have said, we see nothing to indicate that he should, and we do not think the jury was unreasonable in so viewing the case.

Sylvor and Sherr, law partners of Werner, were actively involved in the preparation of the Grand Coal Venture offering. Each was aware of the devious operations of Laird, and each knew of the T.R.O. against Laird and against themselves as Laird's attorneys. While the evidence against Sylvor and Sherr may not have been as overwhelming as that against Werner, it was not reversible error for the jury to find Rule 10b-5 liability on the basis of their conduct. *See Bloor* v. *Carro, Spanbock, Londin, Rodman & Fass,* 754 F.2d 57, 62 (2d Cir. 1985).

Bandler & Kass was actively involved in the Grand Coal Venture offering as well. Not only were three of the principals in the venture Bandler & Kass partners who utilized the firm's facilities to market their fraudulent scheme, but Freschi's checks investing funds in the venture were made out to "Bander & Kass, Special Account," and accepted by the firm for payment to that account. Thus it was not error for the jury to find Bandler & Kass liable under Rule 10b-5. Similarly, the jury did not err in finding 10b-5 liability on the part of Ground Production Corporation, which marketed the Grand Coal Venture units.

Defendant-appellant Jack Mitnick was Venture Administrator for Grand Coal Venture. The record is absolutely devoid of any showing that he made any misrepresentations to Freschi, or knowingly assisted anyone else in doing so, before Freschi made the investment in December 1977. Since a misrepresentation is actionable under Rule 10b-5 only if it is

made in the course of the purchase or sale of a security, Mitnick cannot be held liable for a 10b-5 violation. The judgment to the contrary must be reversed.[11]

Defendant-appellant Baker's role was essentially that of a middleman conveying the leases from Laird to Werner, Sylvor and Sherr. The record establishes that Baker supplied Laird with false geological reports and that the sponsors of the Spruce Productions offering made use of those reports in preparing their prospectus. Baker submitted reports, as president of a consulting firm called Mineral Resources Development, giving Grand Coal Venture his opinion that the leased land contained large quantities of coal reserves. These opinions, of course, turned out to be erroneous. There is evidence, moreover, that Baker knew these representations to be false or acted with reckless disregard as to their truth. For example, his reports indicated that sub-bituminous coal was available on leased land in North Dakota, while it is a well-known fact in geological circles (as an expert witness testified) that there is no sub-bituminous coal in North Dakota. In addition, there were other misrepresentations in Baker's report. For example, he took advantage of the fact that one of his staff geologists had recently married and therefore changed her name, to give the impression that her reports before and after the marriage represented the independent findings of two different geologists. The evidence also suggests that he overrepresented his own geological qualifications. All of these representations, moreover, were made to the parties marketing Grand Coal Venture prior to the time Freschi made his investment. Although the case as to Baker's liability is a closer one than that as to the other defendants, we think that there was enough evidence for the

[11] Mitnick's conduct as Venture Administrator arguably violated his fiduciary duties to the investors. He was not held liable, however, under any such theory. As noted below, the jury properly held Mitnick liable for fraud.

jury at least to have found Baker to be a knowing aider and abettor of the 10b-5 violations. Accordingly, we do not reverse the judgment as to Baker.

We now turn to the common law fraud count, on which the jury found all defendants except Sherr liable. The parties agree that the substantive law governing this count is that of New York. As we noted in *Mallis* v. *Bankers Trust Co.*, 615 F.2d 68 (2d Cir. 1980), *cert. denied*, 449 U.S. 1123 (1981), the elements of fraud in New York are representation of a material fact, falsity of that representation, scienter, reliance, and damages. *Id.* at 80 *(citing JoAnn Homes v. Devorety*, 25 N.Y.2d 112, 119, 302 N.Y.S.2d 799, 803 (1969) and 24 N.Y. Jur., Fraud & Deceit § 14 at 47-48 (1962)). We have discussed all these points in connection with the 10b-5 claim, and it would be repetitious for us to engage in separate discussion here. Our prior discussion of why the jury's findings of 10b-5 liability as to Werner, Sylvor, Baker, Ground Production Corporation, and Bandler & Kass were proper makes it sufficiently clear why the jury was also justified in finding these parties liable for fraud. We further note that while we reversed the finding of 10b-5 liability as to Mitnick, on the ground that he did not make any misrepresentations prior to Freschi's investment, the record amply demonstrates that he committed fraud by his misrepresentations to Freschi in the course of his administration of the investment, by which he attempted to conceal the worthlessness of Freschi's investment from him. For example, Mitnick signed letters dated August 22, 1978 and March 31, 1979 making representations to participants about Grand Coal Venture's attempts to obtain substitute coal-producing properties. These were knowing false representations on which Freschi relied. He was harmed by these statements, in that they prevented him from taking action sooner to recover his money. Accordingly, we affirm the finding of liability as to Mitnick on the fraud count.

The final contention of appellants we must address with respect to the findings of liability is that the court committed reversible error by allowing plaintiff's counsel, in closing argument, to refer to Freschi's belief that his leases guaranteed him replacement properties, in spite of the fact that the court had ruled that Freschi could not reasonably have held such a belief. We fail to see how appellants could have been prejudiced by this argument. The heart of the fraud consisted of the misrepresentations concerning the substitution of Grand Coal Venture for Spruce Productions and the attendant cover-up as to the Laird connection and the temporary restraining order. The evidence as to these misrepresentations was overwhelming, and would have been no less so without counsel's argument on an extraneous issue.

We turn now to the question of damages. There is no question that the trust lost its entire investment, the amount of which was $266,500. Before we determine the amount of the trust's damages, however, we have to consider the effect of any tax consequences. First, we must consider whether the trust's damages must be reduced by any tax deduction obtained as a result of the loss, in light of the principles we recently announced in *Salcer*, 744 F.2d at 935. Second, we must consider whether Freschi is entitled, as he argues on cross-appeal, to damages as a result of any adverse tax consequences which he would have avoided if the Grand Coal Venture had been a legitimate tax shelter.

In *Salcer*, we said:

> . . . § 28a of the Exchange Act [15 U.S.C. § 78bb (a)] . . . limits plaintiffs to recovery of their actual net economic loss . . . . In applying § 28(a) we cannot ignore the substantial economic tax benefits bargained for and realized by plaintiffs.

Salcer, supra, at 941. In this case, the trust sustained losses of $266,500 as a result of its investment. Since IRS allowed

the trust's beneficiary a $266,500 deduction from ordinary income as a result, however, and since this resulted in a tax savings of $188,682, the trust's actual loss was only $77,818. Application of *Salcer* requires that this actual net loss constitute Freschi's recovery on behalf of the trust.

Freschi argues, on cross-appeal, that his damages should be increased to compensate the trust for tax savings it would have realized had the full deductions been allowed. The district court correctly held that a Rule 10b-5 plaintiff can be compensated only for actual damages, and that any award in compensation for hoped-for tax savings would be an impermissible award of damages arising from an expectation interest. *See, e.g., Levine* v. *Seilon, Inc.*, 439 F.2d 328, 334 (2d Cir. 1971); *Chasins* v. *Smith, Barney & Co., Inc.*, 438 F.2d 1167, 1173 (2d Cir. 1970). Similarly, the trial court noted that the interest and penalties IRS assessed against the senior Freschi were not consequential damage; rather, they were simply compensation to IRS for the use of money IRS would have had if the senior Freschi had not wrongly withheld it. The interest and penalties were not, the trial court correctly observed, really a damage suffered by the senior Freschi at all, but a return by him of what would otherwise be a windfall resulting from his opportunity to use money to which he was not entitled.

III.

In conclusion, we AFFIRM the jury findings of 10b-5 violations on the part of Werner, Sylvor, Sherr, Baker, Bandler & Kass, and Ground Production Corporation, and the findings of common law fraud as to all the above except Sherr. We REVERSE the jury's finding of liability as to Mitnick on the 10b-5 count, but AFFIRM the judgment against him on the fraud count. We remand, with instructions that the order of remittitur be amended, so that Freschi is offered a choice be-

tween damages of $77,818 (plus pre-judgment interest)[12] and a new trial.

Freschi's cross-appeal asks that, in the event the remittitur is altered, the trial court be instructed to allow him to proceed on legal malpractice, breach of contract, and RICO (18 U.S.C. § 1961 *et seq.*) counts in the event he should elect a new trial. Because we believe that the trial court was correct in granting judgment non obstante veredicto on the first of these counts, directing a verdict for defendants on the second, and denying Freschi leave to amend his complaint to add the third, we deny this request.

The judgment of the district court is affirmed in part and reversed in part. This case is remanded for further proceedings not inconsistent with this opinion.[13]

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[12] In awarding pre-judgment interest only on $77,818, we are assuming that IRS, in charging Freschi interest on the taxes it determined he owed, did not charge interest on tax payments withheld as a result of the $266,500 deduction, which was ultimately allowed. If this assumption is erroneous and IRS did at some point charge Freschi interest on taxes withheld as a result of the $266,500 deduction, pre-judgment interest should be appropriately increased.

[13] Because the attorney-defendants in this case (Werner, Sylvor, Sherr, and Mitnick) committed actions raising serious questions as to their professional integrity, and because it is not clear from the record exactly what disciplinary action has been taken against them, we instruct the clerk to send copies of this opinion to the appropriate professional conduct review committees.

Appendix B

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

----------x

WILLIAM FRESCHI, JR., As Trustee of the WILLIAM FRESCHI TRUST,
Plaintiff,

-against- 81 Civ. 4331 (RWS)

GRAND COAL VENTURE, et al., OPINION
Defendants.

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SWEET, D.J.

This motion is brought by the defendants in this action, other than William C. Sherr ("defendants") pursuant to Fed.R.Civ.P. 60(b), seeking an amendment of the judgment entered in this case on August 14, 1984. The motion is denied.

Procedural History

Following a jury trial terminating on the eve of the Memorial Day weekend, William Freschi, Jr., as Trustee of William Freschi Trust ("Freschi") was awarded $1,366,396.07 in addition to expenses and interest in this fraud action. In an order of June 28, 1984 this court granted defendants' motion to set aside the judgment and to grant a new trial, and in an opinion dated July 10, 1984 this court offered Freschi a remittitur of $266,500 plus prejudgment interest. Freschi accepted the remittitur, and on August 14, 1984, a judgment was entered. An appeal on numerous issues was docketed with the Second Circuit on September 14, 1984. On September 19, 1984 the Second Circuit issued an opinion in *Salcer v. Envicon Equities,* Docket Nos. 84-7183, 84-7185, 84-7187, 84-7189, 84-7191 and on October 5, 1984 the defendants brought a notice of motion pursuant to Fed.R.Civ.P. 60(b). This motion was argued on October 19, 1984.

Law

According to the defendants, the opinion in *Salcer, supra,* necessitates correction of this court's calculation of the remittitur and the recalculated remittitur should be offered to Freschi before the appeal of the first judgment. In light of *Salcer,* they maintain, the prior remittitur and judgment constitute mistake requiring correction pursuant to Fed.R.Civ.P. 60(b)(1).

A motion under Rule 60(b) "is addressed to the sound discretion of the trial court," *Matter of Emergency Beacon Corp.*, 666 F.2d 754, 760 (2d Cir. 1981), *Altman v. Connolly*, 456 F.2d 1114 (2d Cir. 1972), and a "district court is given a broad discretion to deny or grant relief in light of the particular circumstances of the case." 7 *Moore's Federal Practice* ¶ 60.18[8] (1983 Cum.Ed.) Although rule 60(b) is to be construed liberally, it was "not intended as a substitute for a direct appeal from an erroneous judgment." *Schildhaus v. Hoe*, 335 F.2d 529, 531 (2d Cir. 1964); *Silk v. Sandaual*, 435 F.2d 1266 (1st Cir. 1971); *Weiner v. Sherburne Corporation*, 57 F.R.D. 636 (D.Vt. 1972).

The defendants rely exclusively upon *Tarkington v. United States Lines Co.*, 222 F.2d 358 (2d Cir. 1955) to support their view that *Salcer* justifies granting a Rule 60(b) motion. The Second Circuit, however, has limited *Tarkington* to its facts and characterized it as an exception. In *Schildhaus* the Court observed:

> We allowed [a 60(b) motion] in *Tarkington v. U.S. Lines*, but on very special facts, eleven days after the entry of a defendant's judgment in that case, correct under the law laid down by this Court, the Supreme Court rendered a decision which showed the judgment to be erroneous; the plaintiff moved under Rule 60(b) ten days thereafter, within the 30-day period allowed for appeal. Under such circumstances there is indeed good sense in permitting the trial court to correct its own error and, if it refuses, in allowing a timely appeal from the refusal; no good purpose is served by requiring the parties to appeal to a higher court, often requiring remand for further trial proceedings, *when the trial court is equally able to correct its decision in the light of new authority on application made within the time permitted for appeal.*
>
> * * *
>
> Professor Moore says that a reasonable time for making a motion under Rule 60(b) on the basis of judicial error should not exceed that allowed for an appeal. (emphasis added)

Schildhaus, supra, at 531.

In *In Re Texlon Corp.*, 596 F.2d 1092 (2d Cir. 1979), the Court again referred to *Tarkington* as constituting "very special facts" and held that the "reasonable time" limitation of Rule 60(b) should be read to constitute a requirement that the motion be brought within the time permitted to appeal the judgment. *Texlon, supra,* at 1100. *See also* 7 *Moore's Federal Practice* ¶ 60.22[4] ("A reasonable time for relief from an error of law by the court should not exceed the time allowed for an appeal.") *See* 11 Wright & Miller, *Federal Practice & Procedure* § 2858 (easiest cases to deny Rule 60(b) motions involve allegations of fundamental misconception of the law by the district court where the motion was not made until after the time for appeal had run.)

In this case, the judgment was entered on August 14, 1985, and the time to appeal expired thirty days thereafter. The notice of Rule 60(b) motion was filed October 5, 1984 beyond the period in which 60(b) motions may be brought in this Circuit.

Further, the rationale underlying the use of Rule 60(b) is to permit the district court to correct an erroneous judgment and thereby avoid the necessity of appeal. *See Schildhaus, supra, Fackelman v. Bell,* 564 F.2d 734 (5th Cir. 1977). In the present case, there are several issues being appealed, and the effect of granting the motion and reducing the amount of the proposed remittitur might be only to delay the final adjudication of this case. If the amount of the remittitur were reduced and the plaintiff refused to accept the proposed amount, a new trial would be held without any clarification of the other issues being appealed. The possibility would then exist of a subsequent appeal and remand and yet a third trial. If, on the other hand, the plaintiff accepted the reduced remittitur, an appeal would still follow. It does not appear clear that granting the Rule 60(b) motion will serve the purposes of judicial efficiency underlying the Rule.

Conclusion

For the reasons stated above and in the exercise of my discretion, I deny the Rule 60(b) motion.

IT IS SO ORDERED.

DATED: New York, N.Y.
December 6, 1984

ROBERT W. SWEET
U.S.J.D.

Appendix C

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

----------x

WILLIAM FRESCHI, JR., as Trustee of WILLIAM FRESCHI TRUST,

Plaintiff,

-against-

GRAND COAL VENTURE, BANDLER & KASS, GROUND PRODUCTION CORPORATION, WILLIAM J. WERNER, JACK MITNICK, ROBERT SYLVOR, WILLIAM C. SHERR, MINERAL RESOURCES DEVELOPMENT, INC., and H. JEAN BAKER,

Defendants.

81 Civ. 4331 (RWS)
OPINION

----------x

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SWEET, D.J.

By order of June 28, 1984, this court granted defendants' motion to set aside the judgment for a new trial, and stated that plaintiff William Freschi, Jr., as Trustee of the William Freschi Trust ("Freschi"), would be offered a remittitur in a forthcoming opinion. This is that opinion. This opinion also denies Freschi's motion for costs with respect to the disqualification motion, but grants Freschi the costs of this action.

On the eve of Memorial Day weekend, the jury awarded Freschi $440,000 against defendants Bandler & Kass ("Bandler & Kass"), William C. Sherr, Robert Sylvor and William J. Werner for legal malpractice and $926,346.07 against all defendants for liability under Rule 10b-5 and state-law fraud. The jury also awarded Freschi "all expenses incurred both in this action and before the tax courts, plus interest due the IRS on any deficiencies, including all plaintiff's attorneys fees," even though the special verdict form had not posed questions on these topics.

Rule 10b-5 and Fraud Liability

Defendants contend that the trial evidence was insufficient to support the jury's verdict for Freschi on the fraud and Rule 10b-5 counts. They also contend that the jury's verdict denying defendants' statute of limitations defense to the Rule 10b-5 claim was against the weight of the evidence. Defendants have not contended that the jury was improperly instructed on these questions.

To summarize the evidence adduced at this two-week trial would serve little purpose for those who participated in it. There was sufficient evidence to support a conclusion that the defendants failed to disclose certain material facts to Freschi, especially the fact that Joseph Laird was involved with the offering and had been served with a restraining order. The facts adduced at trial do not require as a matter of law the conclusion that Freschi should have suspected the fraud before July 13, 1978, the crucial date for statute of limitations purposes. Accordingly, defendants' motion to set aside the jury's finding of liability on the Rule 10b-5 and fraud counts is denied.

Damages for Fraud and Rule 10b-5

The jury awarded Freschi $926,346.07 for Rule 10b-5 and fraud liability. This award exactly equals the amount of cash Freschi invested plus the extra tax Freschi owed because of the Internal Revenue Service's ("IRS") initial disallowance of Freschi's deductions for 1977 and 1978. It thus appears likely that the jury awarded Freschi benefit-of-the-bargain damages, contrary to the court's instructions. The jury's extensive note on the verdict form was also not based on any instructions given. Whatever the reason for the award, however, it was excessive for the reasons set forth below and must be set aside.

As the jury was instructed, the Securities Exchange Act of 1934 limits recovery to "actual damages." 15 U.S.C. § 78bb(a). The statute does not define this term, and its application to complex fact patterns has raised difficult questions. Our Court of Appeals has explained that the purpose of § 78bb (a) is "to compensate civil plaintiffs for economic loss suffered as a result of wrongs committed in violation of the 1934 Act...." *Osofsky v. Zipf*, 645 F.2d 107, 111 (2d Cir. 1981). The Court has held that, absent special circumstances that are not present in the instant case, *see Osofsky*, 645 F.2d at 111-14, the actual damages of a defrauded purchaser are his out-of-pocket losses — *i.e.*, the difference between the price he paid and the value of what he received." *Levine v. Seilon, Inc.*, 439 F.2d 328, 334 (2d Cir. 1971). In addition, a Rule 10b-5 plaintiff may recover consequential damages if he can "establish the causal nexus with a good deal of certainty." *Zeller v. Bogue Electric Manufacturing Corp.*, 476 F.2d 795, 803 (2d Cir.), *cert. denied*, 414 U.S. 908 (1973).

The parties agree that Freschi's $266,500 investment qualifies as part of his out-of-pocket damages. Freschi contends that he should also be awarded the $659,846.07 of extra taxes he had to pay when the IRS disallowed the deductions he took for the Grand Coal investment on his 1977 and 1978 taxes. An award of Freschi's damages for the tax deductions he had been promised, however, would constitute a benefit-of-the-bargain damage measure, which, as the jury was instructed, is not permissible in these circumstances. *Osofsky, supra; Levine, supra; see also Sharp v. Coopers & Lybrand*, 649 F.2d 175, 190-91 & n.22 (3d Cir 1981), *cert. denied*, 455 U.S 938 (1982).

Defendants contend that the tax benefits Freschi received from his investment in Grand Coal should be deducted from the award for cash invested. The IRS permitted Freschi to take a $266,500 ordinary income deduction for the cash invested on his 1977 return. Defendants have calculated

Freschi's combined state and federal tax rate for 1977 at 70.8%, and concluded that Freschi saved $188,682 (which is 70.8% of $266,500) on his 1977 return because of the deduction, leaving him an after-tax out-of-pocket expense for the investment of $77,818.

Courts have split in determining whether a plaintiff's tax savings resulting from an investment in a tax shelter that has been held to have been fraudulently promoted should be deducted from his damage award. This court held in *Smith v. Bader*, 83 F.R.D. 437 (S.D.N.Y. 1979), that Rule 10b-5 plaintiffs' tax returns were a proper subject of discovery. The courts in *Austin v. Loftsgaarden*, 675 F.2d 168, 183 (8th Cir. 1982), and *Bridgen v. Scott*, 456 F. Supp. 1048, 1061-62 (S.D.Tex. 1978), held that tax deductions should be considered in determining a Rule 10b-5 plaintiff's damages. However, the recent decision in *Burgess v. Premier Corp.*, 727 F.2d 826, 837-38 (9th Cir. March 5, 1984), which neither side brought to the court's attention during the trial, comes to the opposite conclusion. *See also Western Federal Corp. v. Davis*, 553 F. Supp. 818 (D. Ariz. 1982). The question is now pending decision before this Circuit's Court of Appeals in *Salcer v. Envicon Equities Corp.*, Nos. 84-7185, 84-7187, 84-7189 and 84-7191. In an *amicus curiae* brief in *Salcer*, the Securities and Exchange Commission has urged that plaintiffs' tax savings not be offset.

The court holds that a plaintiff's tax savings should not be deducted from his award for cash invested. When a plaintiff has his investment returned to him in a damage award, the tax laws result in the disallowance of the deductions he took on the investment, eliminating much or all of the tax benefits. *See Burgess*, 727 F.2d at 838. Were this effect to be ignored and the tax benefits deducted, the losers would be the government and plaintiffs, and the only winner would be defendants. The rule that most closely approximates actual damages is one that does not deduct plaintiffs' tax savings.

Freschi also contends that he should receive an award for the interest penalty of approximately $264,500 assessed by the IRS after its disallowance of Freschi's 1977 and 1978 deductions for Grand Coal. Such a penalty is assessed to compensate for the fact that the taxpayer, in paying his taxes late, had the use of the tax money from the time it should have been paid until the time it was paid. In this case, Freschi had the use of $337,033.06 from April 15, 1978 until April 15, 1982 and $322,813.01 from April 15, 1979 until April 15, 1984. Assuming an interest rate of 8%, the value of the use of these sums for these periods approximately equals the interest penalty. Accordingly, Freschi has failed to meet the heavy burden a Rule 10b-5 plaintiff faces in attempting to prove consequential damages, *see Zeller, supra,* and an award for the interest penalty is impermissible. *See Baumel v. Rosen,* 412 F.2d 571, 576 (4th Cir. 1969) (interest on sum paid to defrauded seller deducted from award), *cert. denied,* 396 U.S. 1037 (1970); *Chris-Craft Industries, Inc. v. Piper Aircraft Corp.,* 384 F. Supp. 507, 526 (S.D.N.Y. 1974), (denial of consequential damage award for interest charge on debt incurred for carrying investment), *aff'd in relevant part,* 516 F.2d 172, 191-92 (2d Cir. 1975), *rev'd on other grounds,* 430 U.S. 1 (1977).

For these reasons, Freschi's maximum permissible damages under Rule 10b-5 are $266,500. As with those for Rule 10b-5, damages for fraud in New York are measured only by actual pecuniary loss, *Argen v. Dimin,* 447 N.Y.S.2d 530 (2d Dep't 1982), and the maximum permissible award for fraud would also have been $266,500.00. The jury's award for Rule 10b-5 and fraud of $926,346.07 was thus excessive and must be set aside.

Legal Malpractice

Damages for legal malpractice in New York are limited to the value of what was lost as a proximate result of the

malpractice. *Spector v. Mermelstein*, 485 F.2d 474, 480 (2d Cir. 1973); *Titsworth v. Mondo*, 407 N.Y.S.2d 793, 799 (Sup. Ct. 1978). As was shown above, if Freschi receives a damage award of $266,500, he will have been fully compensated for what he lost as a result of defendants' malpractice. For this reason, the jury's award of $440,000 for legal malpractice was excessive and must be set aside in its entirety.

In addition, no evidence was presented to satisfy the "but for" test, which, as the jury was instructed, is an essential element of a legal malpractice action in New York, regardless of whether the malpractice was the customary sort or was a breach of fiduciary duty deriving from the attorney's failure to disclose facts he knew about the investment. *See Spector v. Mermelstein*, 381 F. Supp. 30, 39-40 (S.D.N.Y. 1972), *aff'd*, 485 F.2d 474; *Parker, Chapin, Flattau & Klimpl v. Daelen Corp.*, 399 N.Y.S.2d 222, 224 (1st Dep't 1977).

Remittitur and Prejudgment Interest

The jury's verdict having been set aside, Freschi will be offered a remittitur of $266,500 plus prejudgment interest, as calculated below.

"An award of prejudgment interest in a case involving violations of the federal securities laws rests within the equitable discretion of the district court to be exercised according to considerations of fairness." *Chris-Craft, supra*, 516 F.2d at 191. Such an award should compensate a plaintiff for the lost use of his money. *Id.* N.Y.Civ. Prac. L. § 5001(a), which controls the award of prejudgment interest on the state-law fraud claim, *Mallis v. Bankers Trust Co.*, 717 F.2d 683, 692 n.13 (2d Cir. 1983), provides for prejudgment interest for acts, including fraud, that deprive a plaintiff of possession or enjoyment of property, including money. Interest is awarded under § 5001(b) from the date the damages were incurred.

The two courts that have held that tax benefits should not be subtracted from a Rule 10b-5 damage award held that the tax benefits could be subtracted from damages in the calculation of prejudgment interest. *See Burgess*, 727 F.2d at 838; *Western Federal*, 553 F. Supp. at 821. The Securities and Exchange Commission advocated this approach in its *amicus* brief in *Salcer*. Brief at 16. Under this approach, the court would consider the $266,500 deduction Freschi took on his 1977 return. Assuming an effective tax rate of 70.8%, the deduction saved Freschi $188,682 in taxes, and, as a result, Freschi has been deprived of only $77,818 since April 15, 1978. Under this view, Freschi would be awarded prejudgment interest on only this amount.

However, such a view would consider the tax consequences for the purposes of prejudgment interest and deny such consideration with respect to the main award. If tax treatment is not to be considered on the main award, as discussed above, no principled reason is apparent to differentiate the result with respect to prejudgment interest. In short, the tax consequences of the award will be left to the taxing authorities. Therefore, if Freschi accepts the remittitur, prejudgment interest will be calculated on the entire $266,500 at the rate provided in N.Y.Civ.Prac.L. § 5004.

If Freschi accepts the remittitur of $266,500, the parties will submit proposed judgments regarding the amount of prejudgment interest that will be added to this award in accordance with the holding above. If Freschi does not accept the award, the matter will be set down for trial in September.

Freschi's motion for costs incurred opposing defendants' motion to disqualify his law firm lacks merit because of *Bottaro v. Hatton Associates*, 680 F.2d 895, 897 (2d Cir. 1982), which indicates that a motion by Freschi to disqualify Schwarzfeld, Ganfer & Shore would not have succeeded, and on the ground that Neal Schwarzfeld's "of counsel" position

with Bandler & Kass was published in Martindale-Hubbell and thus Freschi was able to make such a motion before trial.

However, costs and disbursements of this action are awarded to the plaintiff.

IT IS SO ORDERED.

DATED: New York, N.Y.
July 10, 1984

ROBERT W. SWEET
U.S.D.J.

Appendix D

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

----------x

WILLIAM FRESCHI, JR., as Trustee of WILLIAM FRESCHI TRUST,

Plaintiff,

- against -

GRAND COAL VENTURE, BANDLER & KASS, GROUND PRODUCTION CORPORATION, WILLIAM J. WERNER, JACK MITNICK, ROBERT SYLVOR, WILLIAM C. SHERR, MINERAL RESOURCES DEVELOPMENT, INC., and H. JEAN BAKER,

Defendants.

81 Civ. 4331 (RWS)
OPINION

----------x

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SWEET, D.J.

Defendants Grand Coal Venture ("Grand Coal"), Bandler & Kass ("Bandler & Kass"), Ground Production Corporation ("Ground Production"), William J. Werner ("Werner"), Jack Mitnick, Robert Sylvor ("Sylvor"), Mineral Resources Development, Inc. ("Mineral") and H. Jean Baker ("Baker") (collectively, "defendants")[1] have once again moved for summary judgment, this time against all claims in the second amended complaint of plaintiff William Freschi, Jr. ("Freschi"), as trustee of the William Freschi Trust. Alternatively, defendants have moved to stay this action because damages are still uncertain, and to disqualify Freschi's counsel, Bowker, Elmes, Perkins, Mecsas & Gerrard ("Bowker"), if this action proceeds. Freschi has moved for leave to file a third amended complaint that would add a count based on the Organized Crime Control Act of 1970, 18

[1] Defendant William C. Sherr does not join in this motion.

U.S.C. §§ 1961-1968 ("RICO"). For the reasons given below, defendants' summary judgment is granted to the extent stated herein, the disqualification motion is denied, the motion for a stay is granted to the extent stated herein, and Freschi's motion is denied. The facts and prior proceedings in this action are set forth in decisions dated February 1, 1983, September 18, 1982, May 26, 1982 and August 7, 1981, and familiarity with those decisions is assumed.

Section 10(b) Claims

Defendants have moved for summary judgment against Freschi's claim under § 10(b) of the Securities Exchange Act, 15 U.S.C. § 78j(b), contending that (1) none of the misrepresentations Freschi has alleged are material, (2) even if they are, Freschi did not rely on them, and (3) even if he did, the statute of limitations bars this claim. Freschi has pointed to numerous misrepresentations by defendants which he alleges to create a fact question on his claim under § 10(b). However, in this motion, Freschi has emphasized five of these misrepresentations. Those five are:

> (1) The failure to disclose that Werner had been served with a restraining order by the Securities and Exchange Commission ("the Injunction") because of his participation in the offerings by Cal-Am Corporation ("Cal-Am") and the Cambridge Corporation.
>
> (2) The failure to disclose that Joseph R. Laird, Jr. ("Laird") who owned Cal-Am and was named in the Injunction, was to receive 40% of the advance minimum royalty payments made to Ground Production.
>
> (3) The failure to disclose that Baker, who signed the preliminary geologist's report for Grand Coal as president of Mineral, was not a geologist.
>
> (4) The failure to disclose that Grand Coal's coal leases had been supplied by Baker, who had previously supplied

Laird companies with coal leases, and that Baker supplied the leases through Tristar Coal Corp. ("Tristar"), which Freschi contends was affiliated with Laird, and that Laird's coal leases had rarely if ever produced coal.

(5) The failure to disclose that the Grand Coal tax opinion was prepared by a former law partner of Werner.

There is a question of fact as to the materiality of items 1 and 2 above. Both items related to a December 8, 1977 temporary restraining order that, in its first part, enjoined Laird, Cal Am, Cambridge Corp. and their "officers, agents . . . attorneys and those persons in active concert or participation with them who receive actual notice of this order by personal service or otherwise" from violating §§ 5(a) or 5(c) of the Securities Act by offering for sale interests in limited partnerships or investment contracts involving the lease of coal property, unless a registration statement has been filed. The first part exempted offerings that came within § 4(2) of the Securities Act, the private placement exemption. In its second part, the order enjoined the same persons from employing any fraudulent scheme to offer for sale any security referred to in the first part. The Injunction was served on Werner and Bandler & Kass.

In December 1977, Freschi learned of a coal tax shelter called Spruce Productions, Inc. ("Spruce"), the principals of which were Werner, Sylvor and others. After sending his agent to briefly investigate Werner, Freschi delivered $130,000 to Werner to purchase an interest in Spruce. On December 8, 1977, the Injunction was entered, and Bandler & Kass withdrew Spruce and decided to offer Grand Coal, which was designed as a private placement that would therefore not violate the Injunction. The stockholders of Grand Coal were the same as those of Spruce. On December 15, 1977, according to Freschi's affidavit, Werner told Freschi that the Spruce offering was being withdrawn because it did not comport with requirements of the Internal Revenue Service ("IRS").

According to Freschi's affidavit, which defendants have not disputed, Werner told Freschi that Grand Coal was identical to Spruce except for certain modifications to meet IRS objections. In fact, there were other differences between the offerings, including the facts that Spruce involved a lease to each investor of a specific parcel of property, while Grand Coal involved an undivided interest held by all investors, and the fact that Spruce provided that the offeror would represent the investor in a tax audit, while the Grand Coal offering provided that the investor would bear such litigation costs.

The property for Grand Coal was provided by Tristar. Laird has stated that he had no ownership interest in Tristar. However, Richard Knox, an officer of Tristar, stated at his deposition that Laird caused Tristar to be incorporated, that, as an officer of Tristar, he received his salary from Laird; that the Tristar offices were located at the offices of Cal-Am; and that Laird directed Tristar's operations and Laird personally arranged for substitute leases for Grand Coal.

"The basic test of 'materiality' . . . is whether 'a reasonable man would attach importance [to the fact misrepresented] in determining his choice of action in the transaction in question.' " *List v. Fashion Park, Inc.*, 340 F.2d 457, 462 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965). "Account must be taken of all the surrounding circumstances to determine whether the fact under consideration is of such significance that a reasonable investor would weigh it in his decision whether or not to invest." *Chris-Craft Industries, Inc. v. Piper Aircraft Corp.*, 480 F.2d 341, 363 (2d Cir.), *cert. denied*, 414 U.S. 910 (1973).

Defendants' failure to disclose the existence of the Injunction, the fact that it had been served on Werner and Bandler & Kass and Laird's connection to Grand Coal present issues of materiality. In the papers submitted on this motion, defendants have argued that the Grand Coal offering came within the private placement exemption, which is defined in

Securities and Exchange Commission Rule 146, and thus did not come within the terms of the Injunction. However, defendants have offered no proof as to, for example, Rule 146(d)'s requirements concerning the nature or identity of the offerees, or Rule 146(c)'s requirement of an absence of general solicitation or advertising. More importantly, even if the Grand Coal offering came within the private placement exemption, the fact that Werner, an offeror of Grand Coal, Werner's law firm, and Laird, who was closely involved with the offering, had been enjoined, just before Freschi invested in Grand Coal, from selling investment contracts involving coal leases might well be sufficiently material to withstand this motion for summary judgment. In this connection, it is worth noting that item 16(e) to Form S-1 in effect at the time of the offering required disclosure of the fact that any director or executive officer of the registrant had been enjoined from "engaging in or continuing any conduct or practice . . . in connection with the purchase or sale of any security" in the previous ten years.

However, items 3 and 5 are not material. Item 3 is the failure to disclose that Baker was not a geologist. The mere fact that Baker, who signed the report not individually but in his capacity as president of Mineral, was not a geologist, is not so significant that a reasonable investor would have attached importance to it. The same is true of the fact that the Grand Coal tax opinion found in the Grand Coal offering memorandum ("Offering Memorandum") was written by a former law partner of Werner's. Freschi did not receive the Offering Memorandum until months after the investment decision was made. Even if Freschi relied on the opinon, he has not alleged that it contained any inaccuracy. Accordingly, this fact is not material.

I have found that some of the alleged misrepresentations may be material. However, defendants contend that, even if this is true, Freschi did not rely on these facts. Defendants

contend that Freschi was interested only in tax aspects of Grand Coal — not in its potential for profit — thus he would not have relied on the misrepresentations at issue, which, defendants contend, relate solely to Grand Coal's profit potential.

When an omissions is material, "positive proof of reliance is not a prerequisite to discovery." *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 153-54 (1972). A defendant may rebut the *Ute* presumption, however, by demonstrating that there was no reliance — that even had the material facts been disclosed, plaintiff's investment decision would have been the same. *See Shores v. Sklar*, 647 F.2d 462, 468 (5th Cir. 1981), *cert. denied*, 103 S.Ct. 722 (1983); *Rochez Bros., Inc. v. Rhoades*, 491 F.2d 402, 410 (3d Cir. 1974), *cert. denied*, 425 U.S. 993 (1976). The court in *Keirnan v. Homeland, Inc.*, 611 F.2d 785, 788-89 (9th Cir. 1980), applied this rule and held that where the district court had found, after a trial, that plaintiff had invested primarily for tax purposes, defendants had rebutted the presumption that plaintiff, because certain misrepresentations defendants had made to him concerning profit potential were conceded to be material, had relied on those misrepresentations.

Freschi has testified that he invested in Grand Coal with the dual motives of making a profit and receiving tax benefits. This creates a fact question as to nonreliance and thus makes summary judgment inappropriate. "We have repeatedly stated that summary judgment is particularly inappropriate where . . . it is sought on the basis of 'the inferences which the parties seek to have drawn [as to] questions of motive, intent, and subjective feelings and reactions.' " *Friedman v. Meyers*, 482 F.2d 435, 439 (2d Cir. 1973). This also distinguishes *Keirnan*, where the court found *after a trial* that plaintiff was primarily interested in tax aspects of the transaction. In addition, even were the court to find that Freschi invested only for tax reasons, the failure to disclose

the Injunction and Laird's participation in the offering might still be relevant to the likelihood that the offering would produce the desired tax benefits.

Defendants also contend that because Freschi communicated with no defendants other than Werner, the other defendants can at best be liable as aiders and abettors, and that the complaint does not specifically allege secondary liability on the part of these defendants in compliance with Fed.R.Civ.P. 9(b). While greater specificity would be desirable, the defendants here are the principals of the entity in which Freschi invested, and this is not a situation where the complaint does not permit defendants to frame a meaningful response. *Cf. Goldberg v. Meridor*, 81 F.R.D. 105, 111 (S.D.N.Y. 1979); *Kirshner v. Goldberg*, 506 F. Supp. 454, 458-59 (S.D.N.Y. 1981).

Finally, defendants argue that the statute of limitations bars this action because the Offering Memorandum, which Freschi received in March 1978, should have put Freschi on notice of the fraud, and he then had a duty to investigate the offering. Defendants point out that Freschi knew in early 1978 that more than $500,000 of the proceeds of the offering would go to Ground Production, and that the Offering Memorandum stated that there was no assurance as to the amount of coal on the leased property, that the investment was highly speculative, and that there was no assurance that the IRS would permit the desired deductions. On the question of his investigative efforts, Freschi notes that he met with the defendants' agent five times to discuss the offering, had his agent visit the Bandler & Kass office, received letters from defendants and met and talked by telephone with several of the defendants in mid-1978.

In extreme circumstances, summary judgment is appropriate on the question of when the statute of limitations in a § 10(b) action begins to run. *See Arneil v. Ramsey*, 550 F.2d 774, 781 (2d Cir. 1977); *Berry Petroleum Co. v. Adams &*

Peck, 518 F.2d 402, 410 (2d Cir. 1975). However, "[i]ssues of due diligence and constructive knowledge depend on inferences drawn from the facts of each particular case — similar to the type of inferences that must be drawn in determining intent and good faith," on which "summary judgment is particularly inappropriate." *Robertson v. Seidman & Seidman*, 609 F.2d 583, 591 (2d Cir. 1979). As this court stated in its September 28, 1982 opinion,

> Whether the "possibility of fraud should have been apparent," *Klein v. Shields & Co.*, 470 F. 2d 1344, 1347 (2d Cir. 1972) or whether "suspicions ... would have prompted a man of reasonable diligence to conduct further investigations," *Klein v. H.N. Whitney, Goadby & Co.*, 341 F. Supp. 699, 702 (S.D.N.Y. 1971), are issues of fact. This court cannot decide as a matter of law when Freschi discovered or should have discovered defendants' allegedly fraudulent scheme.
>
> Defendants contend that a duty to investigate may have arisen from the inception of Freschi's investment in Grand Coal. They point to the Offering Memorandum which mentioned the high risk involved in the investment and warned that there were no assurances as to either the amount of coal, if any, in the property or the extent to which the IRS would allow the anticipated deductions, if at all. Again, this court cannot conclude as a matter of law that Freschi should have suspected fraud because the investment was high risk and there was no certainty as to its returns.

Freschi v. Grand Coal Venture, 551 F. Supp. 1220, 1226 (S.D.N.Y. 1982).

For these reasons, defendants' motion for summary judgment on the § 10(b) claim is granted to the extent stated herein and otherwise denied.

State-Law Fraud

Defendants contend that the statute of limitations bars Freschi's claim for state-law fraud, that Freschi did not meet

his duty under New York law to investigate the investment, and that the defendants other than Werner cannot be held liable on this claim because they were not in privity with Freschi since they did not communicate with him.

The three-year California statute of limitations applies to this fraud claim, for reasons given in the September 28, 1982 opinion. The parties agree that the statute begins to run at the same time the statute for the § 10(b) claim does — after Freschi should have been on notice of the fraud. The analysis of this issue under the § 10(b) claim thus applies here, and this ground for defendants' motion is rejected for the reasons given in the discussion of that claim. The same is true of the requirement of investigation of the investment.

Defendants have cited no New York case holding that each person alleged to have participated in a fraud is not liable unless he individually communicated with the plaintiff. *Steinberg v. Guild,* 258 N.Y. S.2d 671 (1st Dep't 1965), is inapplicable because it involved a claim of fraud between defendants and a third party, unlike the claims here which involve an alleged fraud by the defendants against the plaintiff. *Atlantic Bank of New York v. Sutton Associates, Inc.,* 321 N.Y.S.2d 380, 381 (1st Dep't 1971), which dismissed a claim by a plaintiff who had dealt only with a co-plaintiff, is similarly inapplicable. It has also been held that New York has a cause of action for aiding and abetting a common law fraud. *Aeronica, Inc. v. Gorin,* 561 F. Supp. 370, 375-76 (S.D.N.Y. 1983). Freschi has presented sufficient facts concerning the other defendants' participation in or aiding and abetting of the alleged fraud to withstand this motion for summary judgment. *See First National Bank v. Level Club,* 272 N.Y.S. 273, 283 (1st Dep't 1934).

Breach of Contract

Defendants have also moved for summary judgment on Freschi's claim for breach of contract. Freschi contends that

Werner told him that Grand Coal would be virtually identical to Spruce, and concerning the latter there had been a warranty of economically recoverable coal reserves. Freschi also contends that the provisions regarding recoverable coal in the lease between Tristar and Ground Production were incorporated by reference into the lease between Ground Production and Grand Coal. Defendants deny that the documents have the contractual effect Freschi contends.

In the September 28, 1982 opinion, considering defendants' previous summary judgment motion on the contract claim, I stated "I conclude that there are genuine issues of fact as to the nature of the defendants' contractual obligations." 551 F. Supp. at 1230-31. Defendants have presented no new evidence or argument to dispel these factual issues. Accordingly, defendants' motion is denied.

Legal Malpractice

Defendants have also moved for summary judgment against Freschi's claim for legal malpractice. Freschi contends that Bandler & Kass, Werner, Sylvor and Sherr, in responding to a letter from the California Department of Corporations, failed to disclose the relationship between TriStar and Grand Coal, which were named in the letter, and Laird and Werner, who had been subjects of the Injunction. Freschi also contends that the defendants failed to notify him of the IRS audit of Grand Coal and failed to take measures to satisfy the IRS's concerns about Grand Coal by undertaking to obtain valuable coal leases for Grand Coal. In addition, Freschi contends that had Werner properly performed the tasks of obtaining the North Dakota property and the substituted properties in Wyoming, he would have assured that the properties leased to Grand Coal contained coal.

I stated in the February 1, 1983 opinion that, even on the record at the time, there were genuine issues of fact concern-

ing the legal malpractice claim. These issues remain, particularly concerning the establishment of the relationship and the element of a legal malpractice claim that, but for the malpractice, Freschi would have proceeded in a different manner. For this reason, defendants' motion is denied.

Disqualification of Bowker

Defendants have, for the third time, moved to disqualify Bowker from representing Freschi. In the February 1, 1983 opinion, this court discussed the disqualification issue thoroughly, and stated that "At this stage of the proceedings the balance of hardships tips in favor of Freschi. If at some point down the road it appears that continuing representation of Freschi by the Bowker firm will prejudice any party to this action, the disqualification motion may be renewed." Slip op. at 6. Discovery has taken place since that opinion, but the new facts that have come to light are not sufficient under the standard set out in the February 1 opinion to call for the granting of defendants' motion.

Motion to Amend the Complaint

Freschi has moved to amend the complaint to add a RICO claim. While leave to amend "shall be freely given when justice so requires," Fed.R.Civ.P. 15(a), "if a complaint ... would be subject to a motion to dismiss under Rule 12(b)(6) ..., it would be an idle move for the court to allow such amendment.... Accordingly, leave to amend may be properly denied." J. Moore, *3 Moore's Federal Practice* ¶ 15.08[4] at 15-109.

The RICO claim is subject to a motion to dismiss. RICO provides a private right of action for treble damages to anyone injured "by reason of" a violation of the substantive section of the statute, 18 U.S.C. § 1962. The Court of Appeals in this Circuit has set forth the two pleading burdens imposed upon

a plaintiff seeking to state a claim for damages under civil RICO. *See Moss v. Morgan Stanley, Inc.*, 719 F.2d 5, 17 (2d Cir. 1983). The plaintiff must first allege adequately that defendant has violated the substantive RICO statute, § 1962, commonly known as "criminal RICO," before turning to the second burden of alleging that he was injured in his business or property "*by reason of* a violation of section 1962." *Id.* The complaint in this action is defective at the second level of inquiry.

The applicable language for the alleged violation in the instant case prohibits any person who has received income derived, directly or indirectly, from a "pattern of racketeering activity" from using such income or the proceeds of such income in the acquisition, establishment or operation of an enterprise, 18 U.S.C. § 1962(a); from acquiring control of an enterprise through a "pattern of racketeering activity," 18 U.S.C. § 1962(b); from conducting the affairs of that enterprise through a "pattern of racketeering activity," 18 U.S.C. § 1962(c); or from conspiring to violate any of the three previous sections. 18 U.S.C. § 1962(d). "Enterprise" includes any individual, partnership, corporation, association, or other legal entity, and any union or group of individuals associated in fact although not a legal entity. 18 U.S.C. § 1961(4). A "pattern of racketeering activity" is defined as the commission of two or more specific criminal acts within a ten-year period, including mail and wire fraud and fraud in the sale of securities. 18 U.S.C. § 1961(5).

Turning to the facts of this action, the proposed RICO claim would allege that defendants, in order to defraud Freschi, disseminated false information to him by mail and by wire, and that these acts constitute indictable offenses under 18 U.S.C. § 1341 (relating to mail fraud) and 18 U.S.C. § 1343 (relating to wire fraud). Freschi also contends that defendants circulated offering materials containing false information in violation of the Securities Exchange Act of 1934.

Since each of these acts may constitute a predicate act for purposes of establishing a "pattern of racketeering activity," Freschi has adequately alleged the necessary predicate acts. 18 U.S.C. § 1961(5).

Freschi contends that the "enterprise" in this case is the association of the defendants for the purposes of defrauding Freschi and other investors and the organization of the various business entities through which the fraud was perpetrated — Ground Production, Spruce and Grand Coal. This adequately alleges an "enterprise" under § 1961(4).

However, the proposed amended complaint fails to allege an injury "by reason of" a § 1962 violation. Although there is division among the Circuits on what constitutes such an injury, a growing number of courts, including this one, have required something more than direct injury from the predicate acts, or a "racketeering enterprise injury," as the only meaningful limitation which can be imposed on the private treble damage provision. In *Harper v. New Japan Securities International, Inc.*, 545 F. Supp. 1002 (C.D.Cal. 1982), the California district court noted that:

> Only if this causal connection [between the alleged injury and the kind of injury RICO was intended to prevent] exists will the policies and purposes of RICO be served by permitting a private right of action. This construction, while avoiding the imposition of the antitrust requirement of "competitive injury," recognizes the similarities between the RICO treble damages provision and § 4 of the Clayton Act. In light of Congress' failure to provide any direction in determining the rules of standing appropriate to the RICO treble damage provision, the antitrust analogy is the construction of the statute which is most likely to reflect Congress' understanding of the words "by reason of."

Id. at 1008. *E.g., Kaufman v. Chase Manhattan Bank,* No. 82-7592, slip op. at 13 (S.D.N.Y. Feb. 15, 1984); *Hudson v.*

LaRouche, No. 83-3292, slip op. at 11 (S.D.N.Y. Dec. 16, 1983); *Gitterman v. Vitoulis*, No. 82-5908, slip op. at 6 (S.D.N.Y. Sept. 28, 1983); *Richardson v. Shearson/American Express Co., Inc.*, 573 F. Supp. 133, 136 (S.D.N.Y. 1983); *Waste Recovery Corp. v. Mahler*, 566 F. Supp. 1466 (S.D.N.Y. 1983); *Bankers Trust v. Feldesman*, 566 F. Supp. 1466 (S.D.N.Y. 1983); *Bankers Trust v. Feldesman*, 566 F. Supp. 1235 (S.D.N.Y. 1983); *Landmark Savings & Loan v. Loeb Rhoades, Hornblower & Co.*, 527 F. Supp. 206, 208 (E.D. Mich. 1981). See also *Moss, supra*, 719 F.2d at 20 n.16, where the Second Circuit did not reach the question of what type of injury is required by § 1964(c) because plaintiff failed to establish the requisite predicate acts, but the Court italicized the words "by reason of" for emphasis. *But cf. Schacht v. Brown*, 711 F.2d 1343, 1358 (7th Cir. 1983), *cert. denied*, 52 U.S.L.W. 3423 (Nov. 28, 1983) (No. 83-548); *Mauriber v. Shearson/American Express*, 567 F. Supp. 1231, 1240 (S.D.N.Y. 1983). In the instant case, Freschi has alleged no facts to support injury "by reason of" other than that resulting from the alleged predicate acts themselves. For this reason, the RICO cause of action fails to state a claim, and the motion to amend is therefore denied.

Motion to Stay the Action

Defendants have moved to stay this action pending settlement of Freschi's father's dispute with the IRS concerning the deductions for Grand Coal. Freschi opposes this motion, contending that the IRS will prevail in the dispute and that, even if Freschi prevails (and is able to take the deduction), his damages should not be reduced by the amount of the deduction.

The value of tax deductions taken for an investment that is the subject of a private securities fraud action must be taken into account in determining plaintiff's damages, since those damages are strictly compensatory. *Smith v. Bader*, 83

F.R.D. 437, 439 (S.D.N.Y. 1979); *Austin v. Loftsgaarden*, 675 F.2d 168, 181-83 (8th Cir. 1982). In his 1977 return, Freschi took a deduction of $520,000 for Grand Coal royalty payments. The IRS disallowed this, permitting only an ordinary deduction of $266,500. In 1978, Freschi also took a $520,000 deduction, but the IRS did not permit any deduction. Freschi testified at his deposition that the disallowance is currently being challenged. At stake in the challenge are the deductions themselves as well as almost $300,000 in interest for tax owed.

In deciding whether to stay an action before it, a court "must weight competing interests and maintain an even balance. . . . [T]he suppliant for a stay must make out a clear case of hardship or inequity in being required to go forward, if there is even a fair possibility that the stay for which he prays will work damage to someone else." *Landis v. North American Co.*, 299 U.S. 248, 255 (1936). A favorable disposition of the tax dispute might well materially affect Freschi's damages. However, this is a 1981 case in which there has been extensive motion practice and discovery. Although, in circumstances similar to these, one court has held that the interests of justice call for a stay pending settlement of the tax litigation, *see Mastan Co. v. Jackson*, 321 F.Supp. 865, 867 (N.D.Ill. 1971), I conclude that the uncertainties of an initial determination should not control the disposition of this action. Any further discovery will be completed by May 7 and the pretrial order submitted by May 14, 1984.

IT IS SO ORDERED.

DATED: New York, N.Y.
March 23, 1984

ROBERT W. SWEET
U.S.D.J.

Appendix E

15 U.S.C. § 78bb. Effect on existing law

(a) Addition of rights and remedies; recovery of actual damages; State securities commissions

The rights and remedies provided by this title shall be in addition to any and all other rights and remedies that may exist at low or in equity; but no person permitted to maintain a suit for damages under the provisions of this title shall recover, through satisfaction of judgment in one or more actions, a total amount in excess of his actual damages on account of the act complained of. Nothing in this title shall affect the jurisdiction of the securities commission (or any agency or officer performing like functions) of any State over any security or any person insofar as it does not conflict with the provisions of this title or the rules and regulations thereunder. No State law which prohibits or regulates the making or promoting of wagering or gaming contracts, or the operation of "bucket shops" or other similar or related activities, shall invalidate any put, call, straddle, option, privilege, or other security, or apply to any activity which is incidental or related to the offer, purchase, sale, exercise, settlement, or closeout of any such instrument, if such instrument is traded pursuant to rules and regulations of a self-regulatory organization that are filed with the Commission pursuant to section 78s (b) of this title.

Appendix F

18 U.S.C. § 1962. Prohibited activities

(a) It shall be unlawful for any person who has received any income derived, directly or indirectly, from a pattern of racketeering activity or through collection of an unlawful debt in which such person has participated as a principal within the meaning of section 2, title 18, United States Code, to use or invest, directly or indirectly, any part of such income, or the proceeds of such income, in acquisition of any interest in, or the establishment or operation of any, enterprise which is engages in, or the activities of which affect, interstate or foreign commerce. A purchase of securities on the open market for purposes of investment, and without the intention of controlling or participating in the control of the issuer, or of assisting another to do so, shall not be unlawful under this subsection if the securities of the issuer held by the purchaser, the members of his immediate family, and his or their accomplices in any pattern or racketeering activity or the collection of an unlawful debt after such purchase do not amount in the aggregate to one percent of the outstanding securities of any one class, and do not confer, either in law or in fact, the power to elect one or more directors of the issuer.

(b) It shall be unlawful for any person through a pattern of racketeering activity or through collection of an unlawful debt to acquire or maintain, directly or indirectly, any interest in or control of any enterprise which is engaged in, or the activities of which affect, interstate or foreign commerce.

(c) It shall be unlawful for any person employed by or associated with any enterprise engaged in, or the activities of which affect, interstate or foreign commerce, to conduct or participate, directly or indirectly in the conduct of such enterprise's affairs through a pattern of racketeering collection of unlawful debt.

(d) It shall be unlawful for any person to conspire to violate provisions of subsections[2] (a), (b), or (c) of this section. [footnote omitted].

* * *

18 U.S.C. § 1964. Civil remedies

(a) The district courts of the United States shall have jurisdiction to prevent and restrain violations of section 1962 of this chapter by issuing appropriate orders, including, but not limited to: ordering any person to divest himself of any interest, direct or indirect, in any enterprise; imposing reasonable restrictions on the future activities or investments of any person, including, but not limited to, prohibiting any person from engaging in the same type of endeavor as the enterprise engaged in, the activities of which affect interstate or foreign commerce; or ordering dissolution or reorganization of any enterprise, making due provision for the rights of innocent persons.

(b) The Attorney General may institute proceedings under this section. In any action brought by the United States under this section, the court shall proceed as soon as practicable to the hearing and determination thereof. Pending final determination thereof, the court may at any time enter such restraining orders or prohibitions, or take such other actions, including the acceptance of satisfactory performance bonds, as it shall deem proper.

(c) Any person injured in his business or property by reason of a violation of section 1962 of this chapter may sue therefor in any appropriate United States district court and shall recover threefold the damages he sustains and the cost of the suit, including a reasonable attorney's fee.

(d) A final judgment or decree rendered in favor of the United States in any criminal proceeding brought by the United

States under this chapter shall estop the defendant from denying the essential allegations of the criminal offense in any subsequent civil proceeding brought by the United States.